M&A Views

# **Deloitte M&A Views podcast:** Impact of the current economic situation on automotive M&A across the value chain

**Greg Jarrett:** Welcome to Deloitte M&A Views, a Deloitte podcast series exploring the latest trends and topics in mergers and acquisitions. I'm Greg Jarett. Today we discuss the impact of the current economic situation on automotive M&A across the value chain. We're joined today by Marc Holzer, a partner in Deloitte's Mergers and Acquisitions transaction services team, and Anthony Blanchard, a managing director in the Deloitte Corporate Finance group. Thanks for joining us guys. Marc, let's start with you, and the original equipment manufacturers, often called the linchpin of the automotive value chain, and what actions they may be considering taking during this COVID-19 crisis, and how the situation today may be different from the financial crisis. Take it away, Marc.

**Marcus Holzer:** Thanks, Greg. I think the OEMs today are really in the eye of the storm, so to speak. They've got challenges on multiple fronts as a result of the crisis. I think first and foremost is really just managing their core operations. The OEM business model is highly dependent on production, and as soon as production shuts off, cash inflows effectively shut off for them, so when you think of a situation of an OEM being down for four weeks or six weeks or even longer, they're effectively cut off from cash inflows, so that creates an immediate and pronounced liquidity issue for them. Even more broadly, their suppliers also start to feel that crunch, although on a delayed basis, and oftentimes in crises like these—certainly during 2008 and 2009—you'd see the suppliers coming to the OEMs for financing. They end up being the bank of last resort.

So the OEMs are trying to manage their own business, satisfy their own obligations, pay their own employees, and keep their own developmental and product launch activities on track, and they're also in some instances being asked to support those activities to some degree at the supplier level. They've also got challenges with their financing companies. Most of the OEMs have captive financing companies that support their dealers, and they're also experiencing challenges. People lose their jobs, they get behind on their car payments—that has a direct impact on the financing companies. Also, vehicle residual values are dropping. This impacts trade in values, values on leased vehicles that are being returned, etc., so they're getting pressures on all sides as it relates to the traditional business.

I think the one area that's different—perhaps in a good way, perhaps not—versus 2008 and 2009 is, it relates to the extent of the investment that OEMs have made in alternative business models, whether that's ridesharing, or taxi services, or development of autonomous vehicle technology, or other transit- or transportation-related solutions. That's significantly different than during the prior crisis. The challenge is, these new business ventures and this new technology development is costing the OEMs hundreds of millions or billions of dollars per year, because none of these businesses have gotten to the point where they're either technologically feasible and working, as in the case of autonomous vehicles or connected vehicles, or generating cash on their own, so the OEMs are funding these activities. It's a drain on capital, that's a drain on resources, so it'll be a real interesting question to see how they support and sustain these activities through the downturn.

One opportunity coming out of this is like valuations, and automotive have decreased, valuations in many of these businesses have decreased, and in fact, were starting to soften before the crisis hit, so OEMs could take advantage of this and acquire people, talent, technology, and potentially new business model investments at a much more attractive valuation than they could have three or six months ago, or they could abandon them altogether and cut off the cash strain, so it will be an interesting strategic question for them to contemplate, but generally speaking, they've got a number of challenges to deal with on a number of fronts, so this will be a very challenging time for them.

**Greg Jarrett:** Well, Marc, listening to you there, it sounds like this is a perfect storm all across the industry, from the people in the metal shop all the way to the showroom. What is happening in the supplier space, and how are the OEMs working with their supply base to make sure the startup does actually go smoothly?

**Marcus Holzer:** The challenges that suppliers are facing are in some respects similar and in some respects different from the OEMs. Much like the OEMs, liquidity is a key issue—these suppliers are generally a fraction of the size of the OEMs and just don't have the financial strength to weather or turmoil like this as well. Unlike the OEMs, they've got a little bit of a reprieve from a cash perspective, because they're working off of past sales with the OEM, so even though the OEMs shut down production, they've still got some level of cash inflows as they collect on receivables from past sales. As we get longer and longer into a shutdown, those cash inflows are slowing, creating a liquidity issue, and when production does start back up, when the OEMs start back up, there'll be a gap that they'll need to find an answer, and that's a critical issue for them.

Even more broadly than that from an operating standpoint, being able to supply the OEMs when they do relaunch production, either themselves or their downstream suppliers, is a key issue. No supplier wants to be the one that shuts down an OEM assembly plant, so being able to control their supply base and communicate with the OEMs around their ability to deliver parts will be a key operational consideration for them. I think, stepping back, much like the impact on OEM equity values, supplier equity values have been adversely affected by the crisis as well. I think this will have a couple long-term or medium-term consequences. One, like we saw coming out of the 2008 and 2009 crisis, there will be supplier consolidation; we'll leave this crisis with larger, better capitalized, but fewer suppliers.

I don't think that consolidation will take place immediately, unless there's distress, which there could be, but over the medium and longer term, there will be consolidation. I think private equity may very well be more active in the space, taking advantage of the distress and the downturn in valuations, and there'll be a lot of activity in this space in the months and years to come as this reset and this reshuffling occurs.

**Greg Jarrett:** But, Tony, you just have to look at miles driven car sales from Asia, to Europe, to the United States, and you can see the cash flow just doesn't exist, which means there's no liquidity. How do you get that back?

**Anthony Blanchard:** Well, it's a great question, Greg, and I think Marc hit on a lot of the key points here. The liquidity needs are really going to drive some tough discussions around access to capital and where you go from here. As we look at it and we think about what the options are that are out there, there are third-party capital providers, and those may look like that, they may look like private equity, but in the current environment, there is a bit of a freeze that's happening, and the access to that capital may be too slow, or it may be too expensive, or maybe both, but those are the types of things that folks are going to have to be thinking about as they're approaching the market.

The second challenge is that there really has been a bit of a belief that there's a reset to valuation, and this environment we're all operating under with not a lot of guidance around what the future may look like makes it somewhat difficult to figure out how to put value on companies, and so a lot of the private equity players, and even the strategists, are looking at this as an opportunity to potentially reset expectations around value, so those are all the things that will be considered and part of the focus here as companies start to look for how they may access some of that capital that's in the market.

**Greg Jarrett:** Well, Tony, we've talked a lot about the suppliers, we've talked about the OEM. How about the people at the end of this chain, the people who are sitting at their homes right now wishing they were working in the showroom, the dealer?

**Anthony Blanchard:** The dealers are really at the tip of the spear in what's happening. You know, they're going through the same liquidity concerns that the rest of the supply chain is looking at. If you were to look at the worst data and some of the sales data, March SAAR was down to 11.4 million units, I believe, and it's about a 32 percent decline over February, and April is predicted to be even worse than that, so they're obviously hurting. They've been able to do some things to address some of the health concerns with cashless delivery and online ordering, but at the end of the day, they have to deal with this lack of demand and overall consumer sentiment, so it's tough—great that the OEMs aren't pumping more inventory into the dealers right now, but they're not moving that inventory either, and they have to deal with paying down their floor plan, financing and curtailments, and things that come along with that, so still burning cash.

Ultimately, it's really a highly fragmented industry, and there's a number of private players in the space, and we would expect that you'll see a lot of consolidation and wind-downs that'll happen through this process.

**Greg Jarrett:** Tony, whenever we see an exogenous shock like this, the hardest-hit of the industries usually sees a lot of M&A activity. Do you foresee that for the automotive industry, which has been very hard-hit in this particular shock?

**Anthony Blanchard:** I think if you were to look at how we entered this market, there was a lot of activity going on. Currently, not a lot is happening, and we don't expect to see a ton of deals being closed unless there was some momentum going in and capital was already aligned, but for the most part, sellers are probably going to sit on the sidelines unless they have to do something in this market. I think we also may see from a strategic investment standpoint that some of the discussion that Marc had mentioned earlier around OEMs, focusing on kind of the next generation, some of that may slow down, and maybe they focus more on securing some of their critical supply chain components and making sure that they can continue supply in, you know, maybe a new world order here.

The last thing I would mention is, from the last downturn in the '08, '09 timeframe, we saw a ton of divestitures picking up. I think if you were to look at some of the banker data, you'd see that there was an increase of about 40 percent in total deal volume that was attributable to divestitures, and at the peak, divestitures made up about 40 percent of the overall M&A activity that was happening in the '09 timeframe, so we typically see that as part of what happens in a downturn, and we would expect that folks will be looking at evaluating their operations and thinking about what might be noncore or maybe something that just is tying up a lot of capital.

**Greg Jarrett:** And, Marc, do you have anything that could help us tie this all up?

**Marcus Holzer:** Again, I think, through the lens of the OEM, critical focus on maintaining operations and liquidity. There was a large OEM merger announced in the latter part of 2019. There's been much speculation over the years that there might be more consolidation. It will be interesting to see if this downturn is like the last ones for some additional consolidation at that level, with companies trying to seek scale and cost savings through size. I also think, as I mentioned earlier, it'll be interesting to see where some of these longer-term bets go. Are we doubling down? Or are we pulling back? And what does that mean in terms of connected vehicles, autonomous vehicles, the timeframe around electrification, etc.?

And then again, just from a supplier perspective, we expect to see fewer larger suppliers at the end of the day. Some of that will be strategy-driven; some of that will be necessity. Private equity will play a role in that. The OEMs might play a role in that over the short term, so I think this crisis will drive—no pun intended—a significant amount of M&A activity and change in the landscape of the automotive value chain over the months and years to come.

**Greg Jarrett:** Thanks, Marc and Tony. We've got some good perspective here on how the current global situation is impacting automotive. I'm Greg Jarett, and thanks for listening to Deloitte M&A Views sponsored by Deloitte's M&A Institute. This podcast is provided by Deloitte and is intended to provide general information only. This podcast is not intended to constitute advice or services of any kind. For additional information about Deloitte, go to deloitte.com/about. We also release new podcasts regularly, and if you subscribe, you won't miss a single one. To stay connected and receive more information on Deloitte's M&A service offerings, visit deloitte.com/us/masubscribe, and follow us on Twitter @DeloitteMnA. Until next time.