Financing the Gap

A challenge, particularly for mid-sized automotive suppliers

Automotive megatrends – Transformation of the whole industry with an uncertain outcome

The much-cited automotive megatrends – e-mobility, connectivity, autonomous driving, and car sharing – will have a far-reaching but very uncertain impact on the entire industry.

Our recently released Deloitte Automotive Value Chain study[1] contains the following core hypotheses:

- Growing market with regional shift, however;
- Loss in volume, increasing costs as well as margin pressure for a variety of conventional components clusters (e.g. transmission and drive strand).
- Highly attractive areas for growth (e.g. driver assistance systems), which require significant R&D expenditure.
- High sensitivity to the expected and, potentially existence-threatening market developments along the value chain.

Innovations require "deep pockets" from suppliers

The approach of original equipment manufacturers (OEMs) will change from being product centric to now focusing on more interaction with customers. At the same time, the technological focus is moving towards electric drives and autonomous driving. The vehicles of tomorrow and the way customers organize their mobility will differ substantially from what we see today.

1 https://www2.deloitte.com/de/de/pages/consumer-industrial-products/articles/automotiv-value-chain-2025.html.

The traditional product innovation process will become obsolete, product life cycles will be shorter, individualization will increase, and new topics such as software engineering will gain in importance. These developments require more innovation in even shorter periods, which puts additional pressure on suppliers to the automotive industry.

Consequently, higher investments, especially in R&D, will be critical for success.

While committing to any specific innovation strategy is hard, experimenting with new products, different technologies and business models is expensive.

Profit pools are shifting

The transformation is particularly challenging for suppliers if their current core business lies in areas that will most likely be replaced by new technologies in the future.

To give an example of a manufacturer of turbochargers; although turbochargers are a product segment without a bright long-term future, sales will nevertheless increase over the next few years while combustion engines are optimized. After this period, sales are likely to decline rapidly, depending on the sensitivity of the market development. Today's goal for any manufacturer of turbochargers should therefore be to develop new markets and segments, possibly even outside of the automotive sector.

Size matters – in particular, traditional mid-sized players face great challenges

Major suppliers, such as Bosch, Continental, Mahle and ZF, are well-positioned for the aforementioned transformation. They have excellent skills in integrating systems and are already shifting their portfolios towards sustainable long-term products.

While small, specialized suppliers present a relatively differentiated picture, medium-sized suppliers are facing a dilemma. Many have poorly differentiated product portfolios, a limited global presence, high pressure on margins and limited financial means.

What can mid-sized suppliers do?

Every supplier needs to individually evaluate how these challenges affect their strategy. However, the following questions apply to them all:

- What product portfolio adjustments are required?
- Is cash flow from the current business sufficient to finance a transformation?
- What financing options are available?
- Is growth in market segments with declining volumes a (financially) viable solution, e.g. by actively driving market consolidation?
- When is the right time to divest product segments or invest in new segments through M&A processes?

Several potential courses of action are available:

Harvest free cash flows in declining market environments

If declining market volumes are expected, one option is to "milk" the current core business. By minimizing R&D and capital expenditures, setting up joint ventures, and establishing cost-cutting programs, free cash flow can be stabilized despite declining earnings contributions.

By concentrating on a niche market, it is also possible to decouple performance from the expected declining market trend, at least to a certain extent or for a certain period.

„Last Man Standing" strategies, i.e. playing an active role in the consolidation process, require a competitive advantage and a strong capital base.

Alternative forms of financing between equity and debt
Traditional bank financing may be limited for transformation strategies, because success cannot be predicted and the past and current order backlog cannot be validated. On the other hand, there is increasing interest from alternative financing partners, e.g. private equity and debt funds, in becoming active in the automotive supplier industry. These investors focus on above-average growth opportunities in new product areas, have a higher risk appetite, and can specifically support mid-sized companies in the transformation, including through their existing networks.

Divestiture of non-core business to free up liquidity
Divestiture of a business unit is another option for financing a transformation. Recently, the Mergers & Acquisitions (M&A) market for suppliers has been very dynamic. Buyers are becoming active in future market segments, but also in areas where long-term developments are less favourable.

„Size matters" continues to be one of the imperatives of the automotive supplier industry. As a result, some buyers are willing to pay an attractive price for businesses with expected declining market development. However, once free cash flows are negative or project pipelines thin out, it will be difficult to achieve an attractive purchase price.

Initial public offerings (IPO) or capital increases
Another option is to raise liquidity for transformation by conducting an IPO or a capital increase. Unsurprisingly, IPOs in the automotive supplier industry increased in 2017. An IPO requires extensive preparation and thus a certain lead-time. The right time window for an IPO is also crucial to its success.

Basic requirement for fundraising: "Make the bride pretty (sustainable!)"
In this situation, improving operations must be more than cosmetic profitability improvements. Comprehensive optimization of business processes and structural measures are often necessary to improve a company's attractiveness. Even though few other industries have reached business process maturity at a comparable level, professional programs can raise comprehensive optimization potentials. Starting these programs early ensures that the expected effects do not just appear on paper, but also show up in the results.

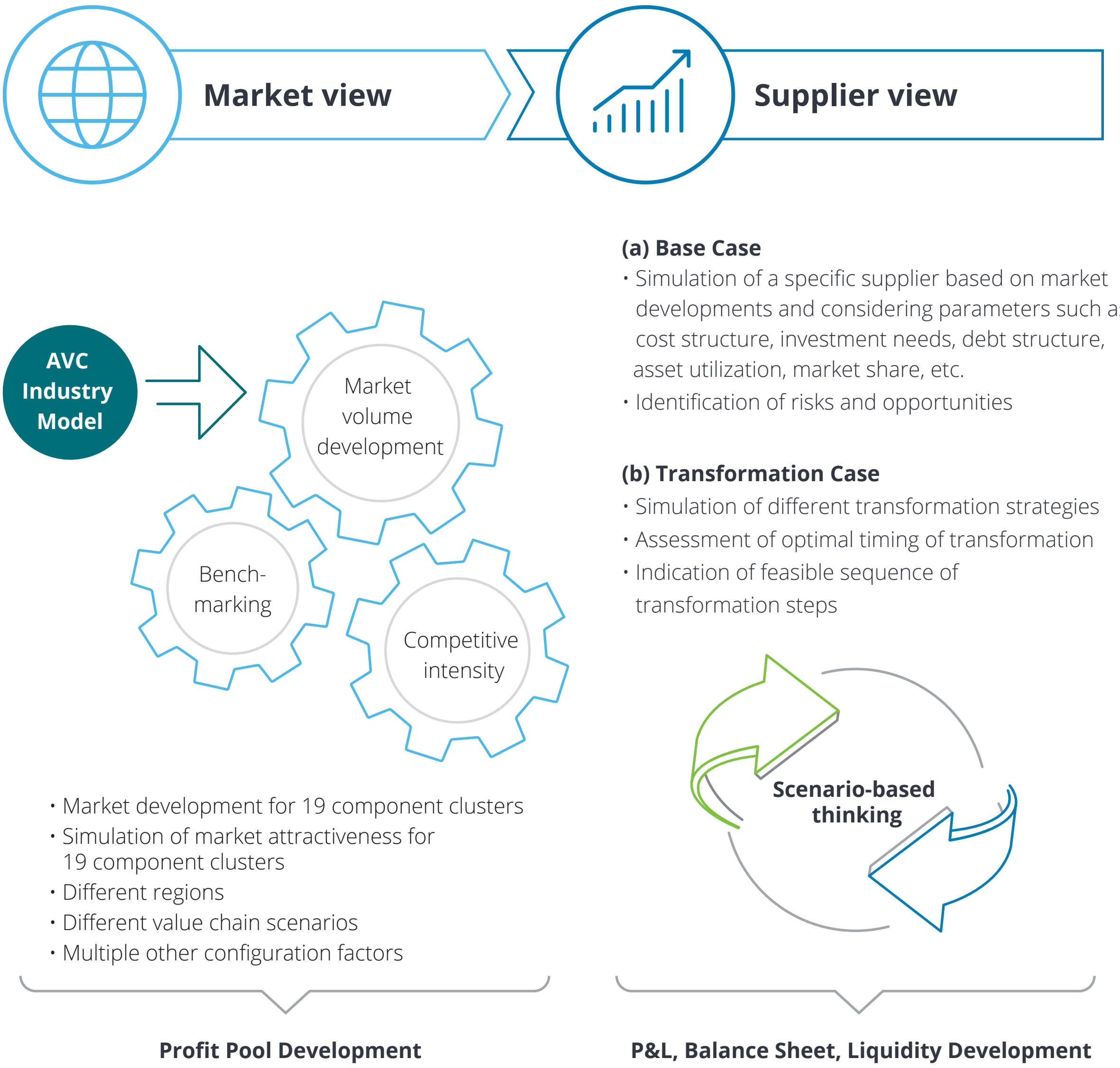
In addition to optimizing current profitability, a stable business strategy is required, even in volatile times, to convince prospective buyers or investors of the business up for sale. It is crucial to show how the business model is exposed to the development of automotive megatrends and how the business plans to participate in the respective growth areas. Therefore, a transformation strategy, backed by different scenarios, is essential.

The Deloitte Supplier Financial Transformation Model

The Deloitte Supplier Financial Transformation Model[2] assists suppliers with the necessary realignment by making key decision criteria tangible and quantifying the financial impacts of potential measures by mapping them onto profit & loss (P&L) statements, balance sheets and cash flow statements.

As a result, it becomes easier to evaluate strategic options, which results in more tangible decisions about potential transformation paths. Our model includes the following core components:

Deloitte Automotive Supplier Financial Transformation Model – Illustrative Structure



2 https://www2.deloitte.com/de/de/pages/finance/articles/automotive-value-chain-supplier-financial-transformation-en.html.

Market view

Market forecasts are based on our Deloitte Automotive Value Chain (AVC) Industry Model. A scenario approach, consisting of four different market scenarios, reflects the uncertainty regarding market developments. The starting point is a breakdown of a vehicle into 19 component clusters. Our AVC Industry Model provides forecasts for each component cluster in terms of market and profit pool development, by looking at various regional markets. Further analyses, such as profitability benchmarks of 450 automotive suppliers and analyses of the M&A, finance and IPO markets, complement a full market view.

Supplier view

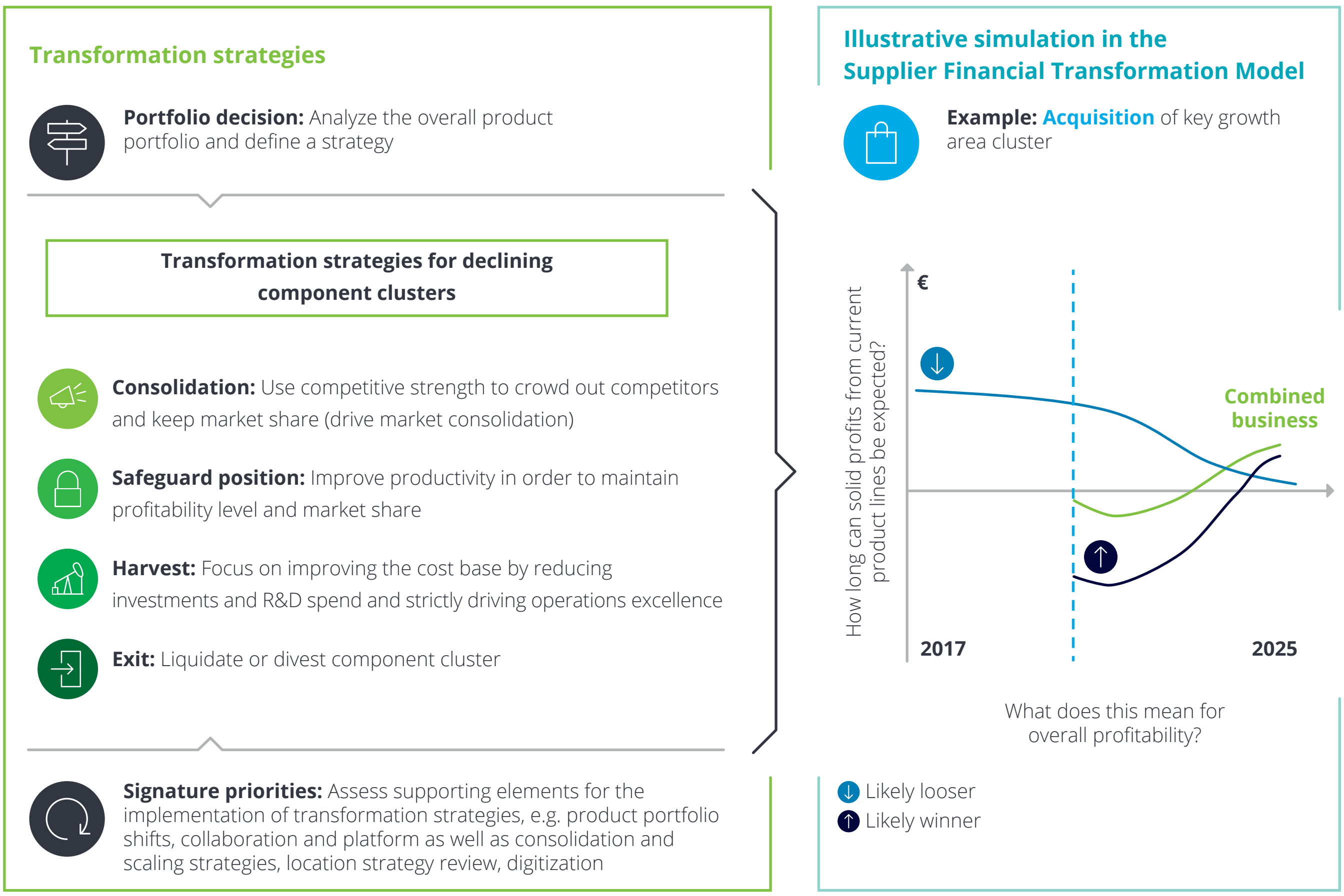
Based on supplier profitability and predicted market developments within the individual component cluster, expected earnings and liquidity developments are modelled, which shows potential transformation requirements for specific automotive supplier segments as well as for individual suppliers.

Transformational strategies

The model can also simulate different strategic options for transforming the business model and their financial impact on individual suppliers:

- M&A scenarios, including an integrated company valuation, can be derived from the model to support a planning approach.
- The liquidity requirements for „wind-down scenarios" can be determined.
- Optimization programs can be included, which means that the possibility of achieving consistently positive returns can be simulated even in a declining market environment.

Supplier Financial Transformation Model | Transformation strategies



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