FTI Consulting Automotive Industry Insights

JUNE 2023

F T I CONSULTING

EXPERTS WITH IMPACT™

Executive Summary

It is common knowledge that the last few years have been challenging for the automotive sector: heightened interest rates, looming recessionary fears, consolidations, supply chain shortages and more. These macroeconomic concerns culminated in an OEM profit decline in 2022 (EBIT 2021: 9.4% vs. 2022: 8.1%) while capital expenditures remained high (2022: $37.8 billion). Margin pressure (EBIT 2021: 5.5% vs. 2022: 5.1%) has also hit the supply base, as both volume and product mix (e.g., electric vehicle ("EV") vs. internal combustion engine ("ICE")) uncertainty made it difficult to develop recovery plans and the long-term strategic investment decisions required to reduce costs.

The industry is being forced to place bets on where and when transformative complexity and demand will appear. Electric vehicle demand continues to increase, forcing the contemplation and conversion of historic ICE production lines to EV. Although the timing, stages and magnitude of this shift remain unclear, the process is clearly being exacerbated by new entrants unencumbered with the infrastructure and debt of traditional OEMs, and who are continuously advancing vehicle technology such as over-the-air upgrades, connected services and digital transformation across the value chain.

Suppliers find themselves in a precarious position within this constantly shifting ecosystem. The automotive industry is different now; suppliers specifically need to understand what these changes mean for them and proactively — and with urgency — ask questions such as: How can I increase the flexibility of my operations to keep up? What can I do to improve revenue mix and use this moment to our advantage? How can I best arm my company to remain relevant?

For automotive suppliers, it will be critical to proactively transform, or they risk becoming irrelevant.

Current state of the automotive industry by the numbers

The automotive industry over the past several years has faced significant challenges, resulting in OEMs unable to meet demand. These challenges, along with the growth in electric vehicle demand, have disrupted a once-stable industry, as legacy players are still figuring out where to invest while fighting off new entrants into the market. Reduced and erratic demand has impacted suppliers' margins and investments, since they had fine-tuned their operations to historical and stable production volumes. The industry is the midst of a transformation driven by changes in technology, customer preferences and regulatory mandates.

(1) Input costs remain high due to inflation…	(2) and the golden era of profits is ending for OEMs and dealers.	(3) All the while traditional pressures continue for suppliers…	(4) and supply chain challenges keep coming…	(5) exacerbated by EV growth…	(6) and requiring a flexible investment approach to accommodate unknowns.
$50K The average transaction price of a new vehicle in the U.S. hit a record high of $49,507 in December 2022, up 4.9% from year-earlier levels.	**34** Inventory days supply in November 2022 compared with 23 days in November 2021.	**3.5 million** Amount of lost vehicles sales globally during 2022 due to supply chain issues; issues unlikely to be resolved in the near term.	**10x** Number of semiconductors required for EVs hitting the market.	**28%** Percentage of sourcing of the parts for EVs that is still left to the suppliers even though OEMs are insourcing more.	**$280 billion** Funneled into innovative automotive hardware and software solutions since 2010; half has gone to EVs.
OEMs and dealers have successfully raised prices to offset inflationary pressures, but due to long-term contracts, suppliers are not benefitting from the additional revenue. Therefore, suppliers need to tune operations and evaluate revenue mix to stop eroding margins.	With vehicle inventories gradually increasing, OEMs and dealers face diminishing pricing power from what they enjoyed in 2021-22; therefore, suppliers should look to offset through renegotiations sooner than later.	Suppliers with the ability to adjust their operations to fluctuating demand and maintain profitability have the opportunity to gain market share from competitors that cannot.	Suppliers face top-line risk if production stalls because OEMs are not able to gain access to semiconductor chips. A focus on inventory management and early identification of supply disruptions will help manage working capital.	By proactively identifying how suppliers can leverage their core competencies in the EV market, OEMs will be better positioned to not only maintain profitability in the near term, but also become a supplier-of-choice for this growing sector.	Accelerated product cycles, expanded product offerings and consumer demand for new technologies in vehicles are fueling an increased emphasis on capital expenditures by OEMs and their suppliers. Suppliers must reduce development cycle time and invest in efficient and flexible assets to control these costs in the future
Supplier Questions					
What can I do to improve revenue mix?	How should I approach customer renegotiations?	How do I increase the flexibility of my operation?	How can I better manage the supply chain and working capital?	How and when should I transition to EV-oriented markets?	Where do I place my long-term bets?

Sources: (1) Kelley Blue Book; (2) December 2022 JP Morgan Equity Research Report; (3) Auto Forecast Solutions; (4 & 5) Detroit News; (6) American Journal of Transportation

Forward-looking trends impacting the supply base

While the industry normalizes from the pandemic shocks and related supply chain constraints of the past few years, numerous headwinds remain that can easily add complexity if not managed properly and proactively. The shift from mechanical to digital is happening within the vehicles themselves as well as in the entire supply chain. Strategic investments will be required across the value stream in order for companies to maintain profitability and relevance in the industry.

Macroeconomic Challenges Will Persist

— Interest rate increases → end of cheap capital for OEMs and suppliers

— Inflationary pressures → rising input costs

— Customer financing → demand concerns

EV Adoption and Transformation Are Accelerating

— Steeper EV growth from accelerated adoption

— Improved battery efficiency and evolving technology

— OEMs with EV-dedicated production lines

— Changing government incentive programs and mandates

Commodity/Raw Materials Prices and Labor Costs Will Remain High

— Input costs: volatile and inelastic

— Wage pressure due to tight labor market and widening talent gap

— Access/reliance on limited resources, most notably semiconductors, lithium and cobalt

Digitization of Products and Operations will Continue

— Supply-based consolidation

— Improved visibility for supply chain enhanced optimization, cost and quality control

— Mechanical-to-digital transformation

Connected Services Business Model Is Still Evolving

— New service ecosystem, including OTA updates, diagnostics and communication

— New demand for software

— Vehicle-to-vehicle communication

— Technology driving new business models for both ICE and EV

Vehicle Lifespan Is Increasing

— Current consumer trend to repair vs. replace cars resulting in increased demand for spares; higher wear and tear on e-hail and ride-sharing services segment

— Used car prices coming down

— EVs requiring less maintenance

New Players Are Entering the Marketplace

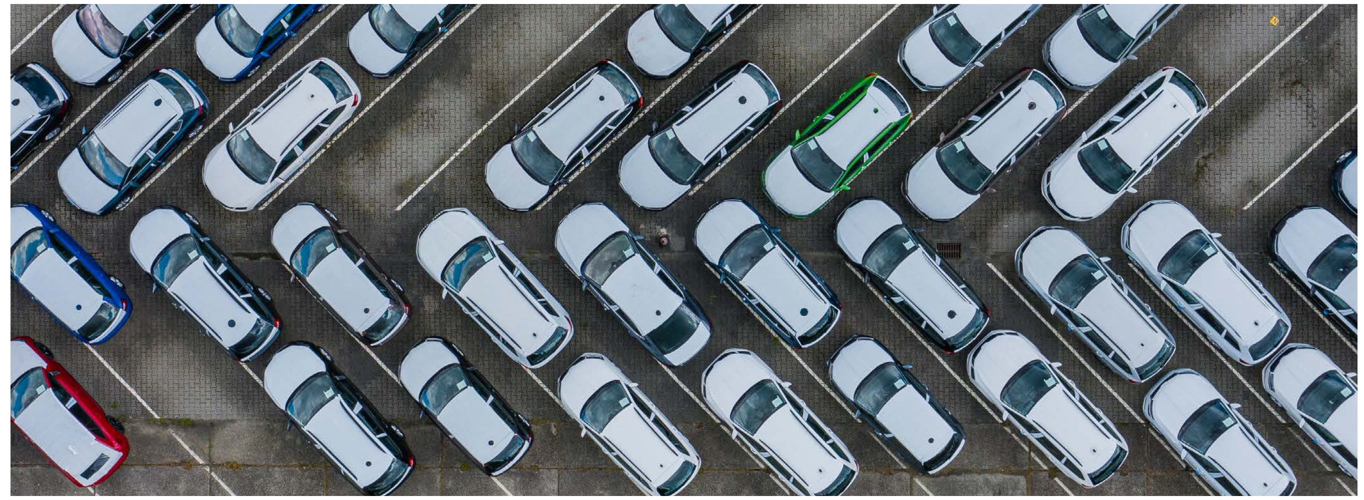
— Large tech entrants

— EV-only entrants as market demand evolves

— Competition in foreign sales from Asian and other non-traditional OEMs

What does this mean for the industry players?

The industry is going through an historic transformation, and while this change will pose some risks to legacy industry participants, it will also create opportunities. Some of the changes can be seen as a negative, but with proper planning and investment, OEMs, suppliers and aftermarket players can position themselves to turn these changes into opportunities for growth and increased profitability. This transition will not happen overnight, but now is the time for companies to determine where they will participate in the future and develop a roadmap for success, because without this positioning, their margins and relevance in the value chain might fade into obsolescence.



Macro Trends	OEMs	Suppliers	Aftermarket and Rest
1 **Macroeconomic Conditions**	Sales environment to invert from premiums above MSRP to pricing incentives Increased borrowing costs will likely dampen vehicle demand	Operating costs, cost of debt will increase Sales and demand levels will continue to be choppy	Inflationary pressures may cause aftermarket auto part stores to win out over higher-cost options
2 **Commodity and Raw Materials Prices**	Ability to push down costs to suppliers Search for substitutes Unionized labor costs potentially rise	Margins continue to be under pressure from increased raw material costs, with limited price relief from OEMs	Cost pressures offset by ability to price and pass through to customers, unlike OE suppliers
3 **Growth in EV Adoption and Transformation**	Development of reliable supply chains while continuing R&D investments and running dual-production lines	EV production utilizes fewer parts than ICE and requires new investment EV parts likely to be higher content per vehicle early in product life cycle	Nascent market that is still defining itself, likely able to push margin to consumers as production ramps Less overall repair and maintenance required
4 **Digitization of Products and Operations**	Extended visibility down the supply chain Predictive technologies enabled in factories and vehicles	Enhanced OEM reporting requirements Big data availability around component performance and quality	Improved quality and performance data Potential restrictions on parts usage (think Apple)
5 **Connected Services**	Additional revenue for on-demand services or vehicle functionality New business models as growth drivers	New suppliers and/or potential partners, entering the market Require non-traditional competencies	Enhanced connection with the customers Ability to create predictive maintenance – and repair-related platforms
6 **Vehicle Lifespan**	Consumers defer upgrades and new auto purchases	Higher margin sales of aftermarket parts offsetting lower production volume	Consumers holding onto vehicles longer should lead to higher maintenance-related sales
7 **New Player Entrants**	Tech companies penetrating the market, driving up competition	Consolidation among peers	Market share captured by OEMs and nontraditional players, e.g., Amazon

Positive Impact   Negative Impact   Neutral Impact

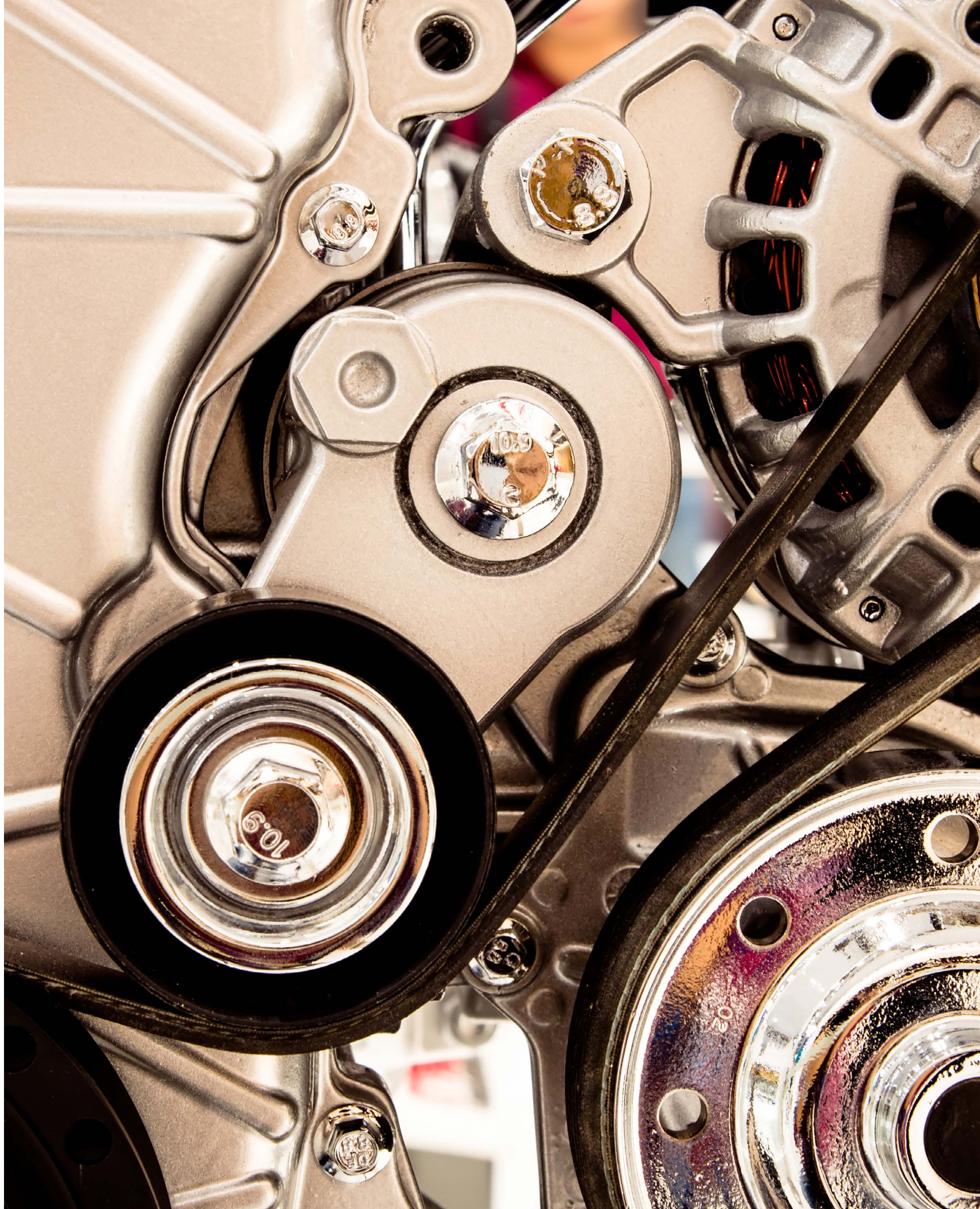
Sources: FTI Consulting Analysis

KEY TAKEAWAYS

The automotive industry outlook in 2023 is one of change. Input cost inflation and supply chain disruptions have created headwinds that have challenged industry participants in terms of sales volumes and margins. The transition to electric vehicles is underway, ushered by changes in consumer preference as well as government regulations within the United States and around the world. Traditional suppliers of components related to internal combustion engines need to start the process of designing their future business models, footprints and service offerings now to ensure they maintain their competitiveness and control their costs in the future. Maintaining a competitive cost structure while still being able to deliver in an environment of declining volumes is not an insignificant task. Inefficiencies and bloated overhead structures that were hidden by historical volumes will become more apparent as the market shift occurs, meaning those companies that are proactive in optimizing their operations while positioning themselves for the unprecedented growth in alternate mobility and powertrain technologies will be the ones that survive and thrive in the future.

Drive-train suppliers are not the only ones that need to take a hard look at their capabilities, performance and future market share as the industry shifts toward less complex portfolios and increasing incorporation of digital technologies. Simply supplying a part will no longer be simple. As OEMs continue to strive to control costs and visibility within their supply chains, they will be increasing pressure on suppliers to modernize their digital capability within operations to provide new levels of transparency. If not done in well-thought-out and strategic ways, this shift to digitization will create additional costs and overhead which the suppliers will be forced to absorb, putting pressure on profitability and liquidity.

The automotive market is seeing a change that it hasn’t experienced since the invention of the modern assembly line. The current shift, however, is more complex than in the past because of the significant investment OEMs and suppliers have in producing today’s vehicles in a high-quality but cost-efficient manner. Maintaining cost competitiveness as volumes are decreasing, while positioning themselves for major transformation, is not something that will just happen. It is something that needs to be acknowledged and planned for. With the right focus, suppliers can overcome these challenges and, if done properly, position themselves to take market share from their competitors and/or consolidate the market and grow profitably.



TEAM EXPERIENCE

FULL COMPANY TURNAROUND PLAN EXECUTION

Global, Tier 1 Automotive Supplier

SITUATION

For a variety of reasons including high overhead costs, operational deficits and unprofitable pricing, a chassis component engineering and manufacturing supplier needed to take action to increase profitability to competitive levels.

OUR ROLE

- Assessed and identified profitability gap though establishment of a reliable database, collection and evaluation of in-progress top- and bottom-line improvement efforts
- Evaluated, prioritized and established timeline for performance improvement initiatives (e.g., sales excellence, procurement, structural consolidation)
- Established PMO structure, measurements, targets, responsibilities, tracking and reporting routines, and communication concepts
- Supported implementation of select initiatives, including production site consolidation (e.g., labor union negotiations and relocation of equipment) and customer repricing negotiations

OUR IMPACT

- Establishment of a comprehensive performance program covering all global sites and functions, including strong commitment from leadership
- Over 20% improvement in operations productivity; includes production site closure
- Over 10% price increases through negotiations with major automotive OEMs

TEAM EXPERIENCE

PROFITABILITY AND COST REDUCTION

Global Automotive Glass Manufacturer/Supplier

SITUATION

Supply chain disruption combined with contracted long-term customer pricing demanded that an automotive glass manufacturer pursue enterprise-wide cost reduction efforts in tandem with the complex challenge of negotiating with (and rationalizing) select, unprofitable customers.

OUR ROLE

- Assessed current/potential key material costs and capacity/productivity planning (including operations, labor and transportation)
- Analyzed long-range commercial plan (including volume projections and contractual pricing) to project future revenue and margins
- Created a profitability model taking into consideration market volatility, variability of recurring and non-recurring costs, and commercial planning
- Developed portfolio of initiatives and execution plan to help company's peer-comparable EBITDA in two to three years

OUR IMPACT

- Identification of performance improvement initiatives in SG&A, spend, supply chain and operations (e.g., leveraging lower-cost operations, reduction of the manufacturing footprint and creation of Centers of Excellence)
- Development of customer negotiation strategies help loss-making programs be profitable

TEAM EXPERIENCE

PRICE RELIEF NEGOTIATIONS

Global, Tier 1 Automotive Supplier

SITUATION

Industry disruption (e.g., customer call-offs, material price increases and energy price increases) negatively impacted profitability and liquidity of a global automotive supplier. An internal team attempted counter-measures but results were ineffective and insufficient.

OUR ROLE

- Assessed transparency on strategic position and financials (per customer), including account negotiation status, review of legal contracts and claims, and financial impact considering major cost drivers and indices
- Developed negotiation strategies, including market considerations, customer-specific storylines and best alternative to negotiation agreement (BATNA) options
- Created implementation timeline, milestones, roles and responsibilities

OUR IMPACT

- Implemented retroactive customer contribution for cost increases and lower volumes without losing future sales volumes
- Negotiated index-based pricing for major cost buckets, reducing input cost risk
- Defined negotiation strategies and standardized minimum requirements, including pricing and contractual terms and conditions

TEAM EXPERIENCE

ACQUISITION DILIGENCE AND SYNERGY CAPTURE

Global, Tier 1 Automotive Supplier Acquiring Carved-out Business Unit

SITUATION

Amid a wave of consolidation at automotive interiors suppliers, our client was acquiring a carve-out business unit from another global supplier, which would double the client's size — an unprecedented pursuit that required assistance with due diligence, synergy analysis and integration program.

OUR ROLE

- Identified potential deal synergies
- Planned and scoped requirements and activities for a successful Day 1
- Transitioned from due diligence and deal negotiation to transaction execution phase
- Planned and launched the integration program and synergy initiatives

OUR IMPACT

- Identification of performance improvement initiatives in SG&A, spend, supply chain and operations (e.g., leveraging lower-cost operations, reduction of manufacturing footprint and creation of Centers of Excellence)
- Development of customer negotiation strategies to help loss-making programs be profitable

How We Can Help

FTI Consulting is uniquely positioned to start working with you and deliver results rapidly.

Deep Industry Expertise

- Automotive and industrial practice with deep experience across the value chain — OEMs, suppliers, aftermarket
- Senior practitioners with operating experience in industry
- Well-recognized thought leaders who have held leadership positions in the industry
- Breadth of capabilities across strategy, enterprise transformation, operations and supply chain, transactions and M&A, restructuring and interim management

Accelerated Results-focused Approach

- Not a “study” – results-focused, actionable outcomes with clearly laid out case for change
- Fast path to implementation with quick hits
- Fact-based and analytical approach, with business judgement to drive action plans
- Unique accelerators and toolkits to deliver with speed and efficiency
- Address key performance indicators and early warning metrics: ability to respond fast

Collaborative and Holistic View

- Collaborative, not intrusive
- Work closely with clients, without overwhelming time demands
- Connect “siloed” information from across the organization to develop insights
- Analytics provide cross-functional visibility and help get consensus across the organization
- Develop proactive risk mitigation and change management plans

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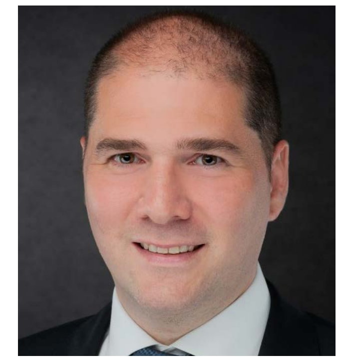

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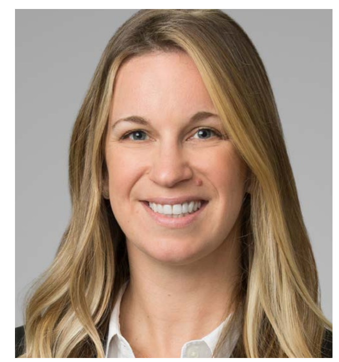

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