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RATIONALIZING THE RECENT LACK OF AUTOMOTIVE SUPPLY RATIONALIZATION

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Given the significant financial restructuring which has occurred in the North American automotive sector in the past couple years and the severe drop in production volumes in 2009, one would assume that the supply base would be currently rationalizing capacity at a torrid pace. When available production capacity is compared to current production levels, one might argue that as much as half of the supply base capacity should disappear in the next five years in order to stabilize the industry in the long-term. Recent trends, such as the following, would indicate that a substantial rationalization of the supply base is in order:

- From 1999 to 2006 new vehicle sales in the US were consistently at or above 17MM units. By 2009, sales had fallen almost 40% to 10.6MM units
- Domestic OEM's appear to be modifying production strategies to supply vehicles in a demand-focused manner in order to reduce excess inventories, increase residuals and improve profitability
- OEM's have explicitly stated objectives to significantly reduce the number of suppliers used (e.g. in August 2009, Ford stated a goal to reduce its supply base from over 2,000 global suppliers in 2008 to 750 in the long run)
- Access to credit and depressed residual values have dried up the market for new car leases which had accounted for as much as 17% of new car sales in 2007
- Based on recent industry volume declines, automotive suppliers as a whole are likely operating at utilization levels around 50% of capacity
- Automotive supplier M&A activity has slowed down precipitously

Despite these trends, the streets are not overflowing with bankrupt suppliers or awash with acquisitions to consolidate supply. In 1Q10 there are very few suppliers being reorganized, sold, or liquidated. Why is there not more rationalization? There are turnaround professionals, investment bankers, and bankruptcy lawyers wondering why the restructuring work and related M&A activity has come to a near standstill. We believe that there may be a few forces at work, such as:

- **Lenders are in "lock down" mode.** It is widely understood that for the past year or so banks have restricted the issuance of new credit while they get their existing portfolios in order. During this time, much emphasis has been placed on banks shoring up their own balance sheets while trying to stabilize profits. Without an abundance of new loans being generated, banks must try

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to maintain or increase the profitability of existing credits. Reducing distressed credits in bank loan portfolios during times like these would lead to (a) realization of losses (if in excess of reserves), and/or (b) elimination of badly needed income. The popular solution … "hunker down" and work on salvaging the existing distressed credits in the portfolio. The result … many credits are in forbearance with higher "default rate" fees and the inevitable is being delayed.

- **The "trickle down" effect of TARP money.** Over $60B made its way from the US Federal Government into the hands of GM and Chrysler, and a portion of it has made its way into the supply base. Automotive OEM's receive their parts in a just-in-time fashion, often from single sourced suppliers. It is not acceptable to allow the supply chain of even one supplier to stop, as it could halt an OEM production facility. As OEM's have increasingly tried to handle distressed suppliers with internal resources, troubled suppliers may be receiving expedited payment terms or advances on new tooling working capital in a quietly orchestrated manner. As a Band-Aid, these measures work - temporarily. However, once a distressed supplier uses up cash generated from shortened customer payment terms, what next? If this practice is currently going on, it's only a matter of time before the dam bursts. Additionally, one has to ask the question, "Who is funding the investment in new design, development, and program tooling for the next generation of vehicles?" Traditionally, up-front tooling working capital has been funded by the supplier only to be reimbursed by the OEM once the tools were validated at production volumes and up-front development and capital investment costs have been recovered in the piece price. Tooling for major programs could run suppliers several million dollars. With restricted credit from banks, and little to no operating cash flow, who is providing the funding for new tooling? Perhaps the OEM's. If so, this would slow down the otherwise expected "weeding out" of the supply base.

- **The upswing in volume hasn't come, yet.** As volumes have declined and the need for working capital has contracted, so too has suppliers' access to expanded lines of credit. As lenders look to reduce their loan portfolio exposure to the automotive supply industry, it has become common to reign in a supplier's access to working capital lines and/or demand a reduction in principal related to term loans in exchange for forbearing on exercising lenders' rights once a default has occurred. These restrictions appear harmless when a supplier's current lending needs are much lower than previously established credit limits, but what happens when automotive volumes rebound and suppliers need to purchase materials to build up inventory and have to wait to collect growing customer receivables? A "survival of the fittest" is right around the corner. Any meaningful increase in volumes will stress the supplier/bank relationships, and we will come to learn who the "chosen" suppliers are.

- **Cost cuts are really working.** It is clear with rising unemployment and a glut of industrial real estate that companies have been cutting costs to weather the storm. We have heard many supplier leaders say, "We had to make the cuts to survive. We thought we might be cutting too deep, but we had no choice. Surprisingly, we're still around and we're now able to break even at 10MM units." If many of the cuts have been in R&D, sales and marketing, what happens when the suppliers need to grow again? Time will tell if the cuts will hamper long-term viability or if a ton of fat has just been trimmed.

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- **The impact of "natural selection" hasn't been felt.** Based on their stated goals of reducing the number of suppliers, the OEM's are likely going through an internal "weeding out" of the supply base. Ultimately, new programs will be awarded to those that are on the "stay" list, and those on the "exit" list will no longer receive new purchase orders and run out current production contracts. The degree to which the transition and rationalization will take place depends very much on the specific products in play and the ability of the surviving suppliers to take on transition business. On paper the gradual transition to a more consolidated supply base looks great, but in reality the transition will likely be difficult as those that are dying seek to acquire or be acquired, to file for bankruptcy protection or to engage in negotiations with the OEM's for one last opportunity to survive.

Although there may be many reasons why there is currently not more supplier carnage, we think that the aforementioned forces account for much of the rationale. Interestingly, the majority of these forces would suggest that the current state of affairs is not sustainable. Therefore, we believe that the automotive supply community is experiencing a "calm before the storm" and that reorganization and capacity rationalization must return to the forefront in order to stabilize the automotive industry over the long-run. Some have even likened the current situation to an industry that has passed through the wall of a hurricane, is currently in the eye, and is awaiting the looming wall ahead. To avoid becoming a casualty of the impending capacity rationalization, suppliers should seek expert guidance to weather the storm.

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