A&M INSIGHTS Cost flexibility: an essential require in the automotive supplier industry Cost flexibility: an essential requirement



How can automotive suppliers remain profitable in a highly volatile environment?

The automotive industry is undergoing a transformation of unparalleled dimension in its history. Powertrain electrification, connectivity, shared mobility, and autonomous driving are challenging existing business models and the entire automotive value chain.

Significant investments will be necessary to successfully transform business models and cope with the challenges of such a disruptive environment. To ensure sufficient financing, industry leaders must either rely on additional equity and debt or need to make sure that their businesses deliver strong cashflows capable of funding investments required. On top of that, predictability in the automotive industry has given way to uncertainty, which suppliers must now master. That means battling high volatility in production volumes that may threaten the resilience of business models or put profitability at risk.

In this article we took a deeper look into

- Why cost structure flexibility is required
- How cost flexibility can be leveraged
- Which cost flexibility levers exist

A key question for suppliers is: How can they increase the flexibility of their cost structure to maintain or regain their profitability despite short-term volume fluctuations.





Why is cost structure flexibility required?

For a long time, the automotive industry was characterised by a high degree of predictability. Production volumes could be forecasted reliably for up to six months and call-offs for the upcoming three weeks were firmly locked-in, in most cases. Production programmes have been well-coordinated between OEMs and suppliers, which also allowed stable planning in the near future.

As a result of this planning, the cost structure could be designed and planned for the medium term to deal with moderate volume fluctuations, without major deviations or lasting effects on their profitability.

Recent developments indicate that these times have come to an end. Especially in the current environment,

Key drivers impacting demand, production and cost volatility

We see four key drivers which substantially change the way the industry operates.

Light Vehicle market decline, including uncertain recovery

Global production volumes prior to the pandemic had already dropped from 2017 to 2019 by approximately 7 per cent. During the pandemic (2019-2020) volumes dropped by additional 11 per cent, with European production falling by 37 per cent. Most relevant markets are currently not expected to recover to the pre-COVID volumes before 2023. In addition to the volume decline, the industry has recently experienced a higher volatility in call-offs due to instable supply chains and raw material shortages. Nevertheless, profitable operations in the existing industrial structures still require a stable and high utilisation. it is crucial for companies to be able to deal with shortterm fluctuations in production volumes appropriately to avoid disproportionate losses in profitability.

A key question for suppliers is: How can they increase the flexibility of their cost structure to maintain or regain their profitability despite short-term volume fluctuations.

While overall global production has fallen, share of electric and hybrid vehicles is rapidly rising



Source: A&M research and analysis; Institute of Automobile Engineers



Source: A&M research and analysis; EV-Volumes.com

Projections for global production of battery electric vehicles have doubled in just one year



Source: A&M research and analysis; IHS Markit data from January 2019 and July 2021

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Accelerated transformation towards e-mobility

While industry experts agree that the transformation towards electric powertrains is at a point of no return, the speed of adoption has accelerated significantly over the last two years. The market share of battery electric vehicles (BEV) is projected to increase to 24 per cent in 2028, compared to projections made in 2019 which forecasted the BEV share in 2028 at only 12 per cent. This trend is a challenge for suppliers, especially for those which still have a high share of their product portfolio focused on legacy technology.

Increasing model variety and changing customer demand 3

The increasing range of model types in the marketplace, with new BEV models competing alongside internal combustion engines (ICE) or plug-in hybrid models, escalates the complexity and reduces the scalability of costs in parallel. In addition, regional differences in the speed of technical transformation in companies adds to the complexity. At the same time,

changes in customer demand will be more difficult to predict. While demand for SUVs increased at a higher pace than expected in recent years, volume forecasts for other segments, like sedans, are facing considerable decreases. OEMs that focus on the wrong vehicle models will be hit by less demand and thus might negatively affect supplier production volumes too.



The expected production of electric and hybrid vehicles will vary widely by geography

Source: A&M research and analysis; Statista data from October 2020

Supply shortage and material price increases

The industry is already experiencing substantial challenges in short-term production due to the limited availability of essential components. In some cases, such as the current semiconductor crisis, supply shortages have led OEMs to halt production, magnifying the impact on suppliers' production volumes and costs.

Shortages of components necessary to produce new technology vehicles is increasing, leading to significantly higher prices



Source: A&M research and analysis; Gartner



Price increase between January 2020 and August 2021

Source: A&M research and analysis; Capital IQ

The latest forecasts illustrate the magnitude of this issue: up to eleven million fewer vehicles are projected to be produced in 2021. Furthermore, the sector currently is dealing with increasing raw material and freight costs. Whether suppliers can pass on price increases to customers is a question of contract terms and conditions. In many cases, the supplier must compensate for the price fluctuations. The same applies to freight costs. The current volatile price increases lead to further pressure on suppliers to act.



How to leverage cost flexibility?

A high volatility in production volumes will in most cases — lead to increasing fixed costs per unit. To avoid negative impacts on margin and profitability, suppliers need to implement appropriate counter measures.

Since suppliers are not positioned to predict or influence the volatility of production forecasts in a sufficient manner, the only remaining option is to pro-actively and timely adjust their costs. Short-term results of such measures will only be achieved if the underlying cost structure allows for a sufficient degree of flexibility.

Illustrative correlation of volume volatility with profit margins









Which cost flexibility levers exist?

Companies that can quickly adjust costs during difficult-topredict market fluctuations face a complex task in identifying all its essential cost positions. Below are selected measures which can be taken to adopt cost structures to varying business needs.

Direct production costs



Introduce general, flexible worktime and corresponding flexible shift models structured to meet technical and contractual requirements.



Align the mix of permanent versus temporary employees according to targeted production volume and the required degree of volume flexibility.



Develop a resource-redeployment strategy allowing to shift resources within and across functions or plants.



Review regularly the appropriateness of contracts and guaranteed production capacities and adjust if needed, especially if they are clearly underutilized.



Increase employees' skill versatility and implement a high degree of employee deployment flexibility.



Develop a production postponement strategy which allows for common production processes for different products, with product differentiation brought at final stages of the process.



Maintain flexible manufacturing processes by balancing high automation levels against manual, but more flexible, processes. Consider flexibility when making long-term decisions about automation investments.





Indirect production costs



Consider outsourcing of indirect production processes that impact volume volatility risk, such as internal material supply, logistics, machine maintenance, and similar functions.



Introduce a production strategy for optimizing the entire plant rather than focusing on single production line improvements. This will enable flexibility with indirect production costs.



Install on-site, bonded stores managed by a third party, including all parts on consignment stock like technical and consumable items.

Material costs



Synchronize purchasing terms between customers and suppliers over the project lifetime.



Increase raw material pass-through strategies to improve the share for existing materials and to incorporate new materials destined for electric drivetrains. These may include copper and rare earth materials, for example.



Improve general commonality of materials and parts, and reduce varying SKUs.

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Increase the outsourcing level of administrative functions, such as human resources (HR), finance, and information technology (IT) processes.



Standardize and streamline internal administration processes and workflows.



Introduce self-service employee options for functions such as HR, Finance, and IT.

Increase the level of automation (low cost/complexity) for specific back-office functions, such as invoicing, creditor and debtor management, HR and accounting.



Incorporate flexibility measures in software license agreements, reduce service levels, reduce demand volume, limit capacity of development environments, and postpone new developments.



Implement energy saving solutions to minimise consumption during production lows or downtime.



Secure contracts with energy providers that are cost effective in supporting changes in consumption, including a hybrid of fixed and variable options.



Other enablers

Ensure flexible, transparent and integrated production scheduling and planning processes, including stable software solutions.

Define strategic targets for production volumes, including the degree of flexibility required or wanted.

Run scenario analyses for alternative assumptions on volumes, prices and costs including potential implications on profitability as well as liquidity situation.

Align operational structure with legal entity and financial structure to increase flexibility (e.g. facilitate carve-outs) if needed.

Summary

Identifying and implementing appropriate measures to increase flexibility of a corporations cost structure is of paramount importance for automotive suppliers. To be able to properly react to short- and mid-term capacity changes is a key success factor to maintaining or regaining profitability during a period of production volume volatility.

Suppliers in different sub-industries will have different cost elements to be considered and depend on the degree of cost efficiency already implemented.

Cost flexibility does not come for free. Developing a more flexible cost structure could impact the general profitability of a company. Balancing investments in cost restructuring and profitability is important and needs to be calculated precisely before rolling out initiatives. Ideally, a financial model will allow leaders to calculate scenarios that illustrate how different degrees of flexibility will affect profitability during certain periods of volume volatility. Identifying and implementing appropriate measures to increase flexibility of a corporations cost structure is of paramount importance for automotive suppliers.





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