European Automotive Newsletter

- Restructurings – last resort OEM contributions
- Re-negotiations with OEM
- Cost optimization: what are key levers to address
- Quarterly update of financial KPIs

June 2022

Restructuring of automotive suppliers – last resort OEM contributions?

In the restructuring of automotive suppliers, OEM contributions are seen as the last resort. Based on our extensive project experience, we show which key points need to be considered when involving the main stakeholders in a restructuring process.

The challenges are high and the pressure points on automotive suppliers are increasing. Transformation to e-mobility, increasing raw material and energy prices, supply bottlenecks and production stops are causing higher costs to be shouldered by an industry that is already struggling with lower profitability after the declines in production volumes of recent years. Additionally, call-off volatility increases, and challenges of the Corona crisis remain.

With volumes long term below normative level, the traditional approach based on a balanced effort is often no longer sustainable. Suppliers who want to survive in a highly competitive industry characterised by intense competition and permanent pressure to optimise processes and cost structures will need to develop a more focused portfolio pricing and rationalisation to survive.

In order to succeed in the long-term, supplier will need to consider to switch from a pure commercial approach to an approach which considers predominantly legal and financial aspects. Such approach should not only be considered in the event of an advanced earnings or liquidity crisis. If internal or equity financing resources have been already exploited, restructuring contributions from financiers, customers or employees are often necessary to enable the success of the restructuring. Entering in such discussions already before the crisis arises might be a way to reduce number of turnarounds during the upcoming and ongoing structural change in the automotive industry.

General requirements to obtain OEM contributions		
Strategic relevance *Production competence & know-how, high level of platform-individual and tool-intensive products*	**Raison d'être** *Sustainable long-term competitiveness; focus on production process & cost efficiency*	**Holistic turnaround concept** *A competitive target profitability can be achieved through clearly defined measures*
Contributions as last option *Internal cost optimisation & financing are exhausted; Restructuring is not possible without external support*	**Equal treatment** *Appropriate distribution of contributions to all stakeholders*	**Transparency** *Causes of crises and existing problems are fully disclosed; Opportunities and risks are known*

OEM & stakeholder contributions: Typical process challenges

Interaction between financiers and OEMs not yet sufficiently rehearsed: Restructuring with the involvement of German or European banks follows a lived practice and an uncodified framework for action. This out-of-court process, which is not regulated, has become established in practice over many years. A comparable framework of action has not yet been established between banks and OEMs, which makes these restructuring processes more challenging. Guidelines have to be found anew among the parties involved on a case-by-case basis.

Competition law restricts transparency requirement: Rules of competition law restrict OEMs in direct communication and also in transparent disclosure of the supplier's business and profitability figures. However, these are partly necessary to make remediation decisions or to assess whether required contributions are allocated fairly and appropriately.

Risk of new business on hold during restructuring: In crisis situations, OEMs can impose a freeze on the awarding of new contracts. This serves their own risk prevention, but also to reduce complexity in restructuring processes. This is one of the reasons why the involvement of OEMs in restructuring processes is often extremely hesitant, which in most cases wastes valuable time and makes finding a solution even more difficult. It is essential to keep a potential contract award freeze as short as possible through a swift and well-prepared process in order to avoid future revenue gaps and thus an intensification of existing problems.

Adherence to familiar patterns: Restructuring is cost-intensive, time-critical, often requires unpleasant decisions and decisive action. There are countless examples were sticking to familiar patterns or not admitting the situation over time creates a greater need for rehabilitation with less room for manoeuvre. This must be avoided.

Recommended Action	
Realistic situation assessment	Consistent assessment of the situation including rights and obligations, a realistic evaluation of existing opportunities and risks supported by short- and long-term financial planning are the basis for being able to determine one's own options for action. The identification of all relevant stakeholders and their short- and long-term interests in the context of a restructuring is essential to determine a successful negotiation strategy.
Identify and address problems holistically	Complete and factual assessment of all causes of the crisis, irrespective of the originator, is central to address them comprehensively in a restructuring concept. Ideally, the status quo and possible solutions are presented holistically to the stakeholders.
Involve all parties in a timely manner	The right time to involve the critical stakeholders must be determined according to the situation. In any case, before the first communication, the "homework" needs to be completed.
Appropriate stakeholder interaction	The short-term betterment of individual stakeholders makes it difficult to find a long-term solution. A solution that is economically acceptable for all parties should be found based on a common interest.
Independent and accepted transparency	A restructuring is a special situation that cannot be compared to the daily business of a supplier. Therefore, the management often lacks the experience and knowledge to structure and control such a process in addition to the daily business. If there is also a crisis of trust between the financier or OEM and the management, it may be necessary to have a neutral third party supporting the process. In addition to the necessary expertise in restructuring and the objective position, this third party can also act as a neutral body for data collection and evaluation in case of competition law concerns.

Re-negotiation with OEM

How to design a successful negotiation process to increase revenue without costs

Strong inflation on materials and energy, global supply shortages and Corona hit the automotive supplier industry, which cannot be recovered with normal cost-down measures

Profit levels between OEM and supply base getting more and more unbalanced. OEM also suffer from global supply shortages and need to adapt and cut down production programs based on parts availability, but most of them are also running margin optimised production. Even with reduced production programs, some OEM were recently reporting the best financial results since many years.

> Many suppliers are in a life-threatening situation and urgently require external support

Suppliers are no longer able to recover cost increases by cost-down measures. The increase of producer prices index of above 30% pushes suppliers into a situation where normal counter measures will not close the gap between rising cost base and cost take-out. Some suppliers are already in life-threatening situations, and last resort OEM contributions becomes the silver bullet of restructuring.

Since decades many suppliers are focussing on getting next orders booked and not to unsettle habitual customer relationships. But current situation requires a comprehensive negotiation approach:

Understand where you are and prepare yourself

- Identify **unclaimed** changes in **engineering**, **volumes** or others which had negative impacts
- Understand your **(legal) position,** e.g. volumes, material surcharges and legal obligations
- Understand the **history of the negotiations**, current status and implications from that
- Ensure that your "**homework**" is done (in purchasing, operations, etc.) to avoid "killer-arguments" from OEM
- Ensure your **operational performance** and product quality are in shape to avoid push-back from OEM
- Slice the problem and create **negotiation bundles** for the customer product portfolio

Build a negotiation position
(not only a whish list)

- Evaluate your viable options which may generate high **implicit costs** and **risks** for the **OEM,** e.g. give back contracts, limit volume, relocate, stop business, insolvency scenarios, etc.
- Make the customer understand, that these options are **viable options** for you – even if you start to execute them during negotiation process
- **Avoid a situation in which the OEM feels blackmailed at any costs**

Execute a comprehensive negotiation process

- Distinguish between **negotiation** and **decision taking** – follow the **golden negotiation rule** that a decision taker never negotiates
- Set the **right target already at the beginning** of the process – there is no way to increase the claim during the process
- Understand the **personality** of your counterparts and the **stakeholders** in the background
- Be prepared to run into a **"lose-lose" situation** and proof the willingness to use your negotiation position
- Be clear with yourself what is a **must-have, topic for negotiation and give-aways** – and vice versa: understand OEM's position
- Find a **compromise** – do not expect to reach the maximum

Cost optimisation

What are key cost levers to address to improve profitability?

Automotive suppliers must permanently focus on the optimisation of their costs and processes to maintain their competitiveness.

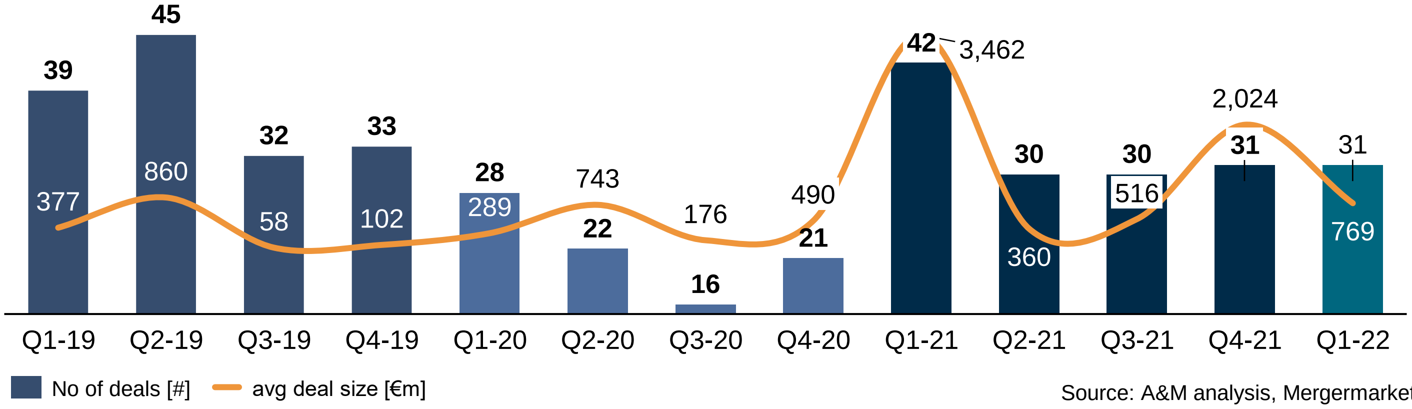
Continuous cost optimisation is key to maintain long term competitiveness. Below we have summarized core elements of cost optimisation which should be included in a recurring review of improvement options. Cost optimisation can require investments and tough decisions. However, not implementing them in order to save money in the short term can massively limit the room for maneuver in the long term.

> Continuous cost improvement needs to be a core capability of a supplier.

Lever	Objective	Impact	Effort
Product cost optimisation	Reduction of material costs via product design and product strategy. Elements: standardisation, harmonisation, simplification	◕	◕
Labour flexibility	Production and administration capacity adjustments to react on volume changes. Production planning and scheduling strategy and execution is key	◕	◑
Organisational efficiency	Limit admin processes and process complexity to core business needs; high level of process standardisation & automation for recurring processes	◑	◑
Production efficiency	Consequent implementation of lean and stable processes and end-to-end optimised value streams; instant mitigation of production flow obstacles	◑	◑
Footprint effectiveness	Long range footprint strategy incl. generation of economies of scale. Anticipation of market developments & availability of competitive workforce	●	◕
Financial & operational transparency	Technical availability of instant monitoring of operational and financial business performance. Ability to initiate counter measures as early as possible. Availability of focused, standardised and actual data is important	◑	◑
Product profitability	Permanent and resilient monitoring of product profitability based on up to date BoMs and Routings to avoid and manage unprofitable business	◑	◑
Procurement excellence	Purchasing strategy implemented with a strong focus on annual savings, supplier management and supplier portfolio risk management	◑	◔
Sales excellence	Consideration design to cost and lifetime cost calculations throughout tender processes. Claim-Management standards to ensure complete billing	◑	◔
Shop floor management	Integrated and data based shopfloor management implemented to maintain shopfloor efficiency and low level of costs of poor quality	◑	◕
Working cap. management	Alignment of contracts, processes and structures to optimise raw material as well as semi-finished and finished product inventories	◑	◔

Questions? Contact our Automotive experts

European M&A activity – Automotive



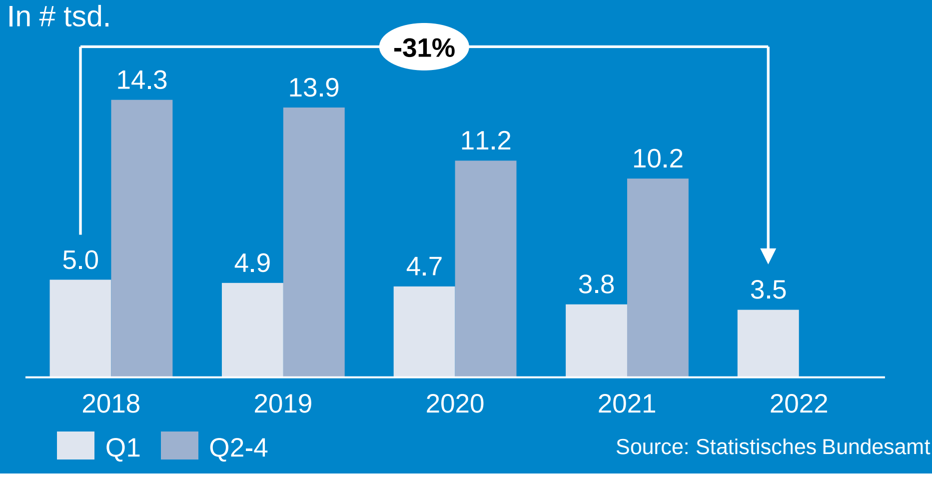
Source: A&M analysis, Mergermarket

The European M&A activity in the Automotive sector with c. 30 transactions per quarter shows a constant development since Q2-21 with the deal size returning to the long term average of c. €750m in Q1-22.

Insolvency filings in Europe as well as in Germany remain on a comparably low level, which is mostly due to the fact that several countries prolonged their state aid programs implemented during the Corona crises at least partially.

Several sources like credit insurances already expected an increase in insolvency filings in HY2 2021, which for most countries did not materialize yet. Additional pressure on the industry due to the Ukraine war might be the trigger that the forecasted increase in insolvency happens in HY2-22.

Insolvency filings Germany



Source: Statistisches Bundesamt

Despite the ongoing economic challenges in Germany, which affect all industries, the number of insolvency filings in Q1 2022 marks another low point of Q1 filings since 2018.

This recent figure published by the German Federal Statistics Office surely does not include the impacts of the war in Ukraine with its massive implications on oil prices and energy costs. The looming recession might cause Q1 or Q2 2022 being the dipping point in terms of insolvency filings.

Transaction activity

In recent transaction news, unfavorable market conditions have failed to halt the IPO momentum with, Swedish EV manufacturer, Polestar, planning to go public in June, and EV startup Atlis Motor Vehicles announcing intentions to go public as soon as this summer. Additionally, powertrain company Vitesco will supply Hyundai with electric-drive modules after signing a $2.1 billion contract with the automaker. Lastly, EV startup Bollinger Motors and engineering services company Roush are partnering to manufacture commercial EVs.

Key transactions

Partnership	Acquisition	Acquisition	Partnership
GM is partnering with Red Hat	Stellantis is acquiring part of Daimler, BMW	Plastic Omnium is acquiring Varroc	Daimler is partnering with Faurecia
Date Announced: May 10, 2022 **Focus:** Vehicle Software	**Date Announced:** May 3, 2022 **Focus:** Shared Mobility Services	**Date Announced:** April 29, 2022 **Focus:** Automotive Lighting	**Date Announced:** April 28, 2022 **Focus:** Connected Vehicles

- General Motors is partnering with Red Hat to advance their software platform and improve the overall customer experience in the OEM's vehicles. The partnership plans to produce an updated and common technology system without sacrificing safety.
- Stellantis agreed to purchase the Share Now car-sharing business from BMW and Mercedes-Benz. The acquisition gives Stellantis competitive positioning in the global car-sharing market, while allowing BMW and Mercedes to concentrate on mobility alliance software.
- Plastic Omnium has agreed to acquire the North American and European lighting units from the lighting supplier Varroc for $634 million. Plastic Omnium is hoping to gain market share and improve capacity utilization while Varroc has aims to focus on the two-wheeler sector and EV product lines globally.
- Mercedes is partnering with the Faurecia-Aptoide joint venture for their infotainment technology system. Faurecia is aiming to solidify their market position, and Mercedes was able to oust tech giants to enhance their vehicles' entertainment systems.

Regulatory landscape

EU combustion engine ban from 2035: The European parliament voted on 8 June 2022 that all new car and van sales should be zero emissions from 2035 as part of efforts to clean up road transport. The legislation needs to be signed off by the environment ministers of the EU member states on 28 June 2022. Despite this new regulation, several countries have much more ambitious plans. Norway targets to ban new registrations of combustion engine powered cars from 2025 onwards. Five years later the EU-countries Denmark, Ireland, the Netherlands, Sweden and Slovenia plan to follow.

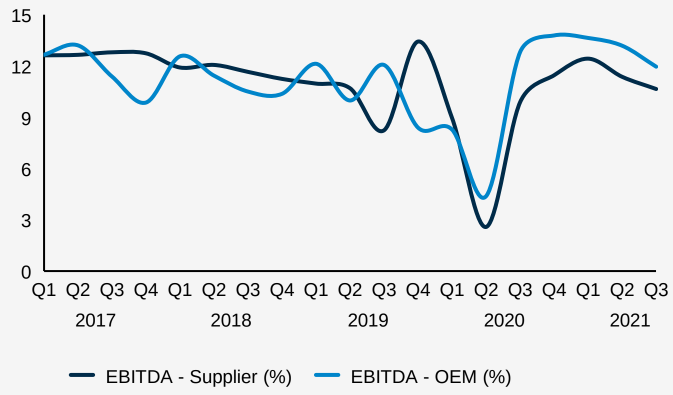
EV Battery Recycling Policy: The Alliance for Automotive Innovation recently released a policy framework for the reusing, repurposing, and recycling of EV batteries. The legislation is purposed to sustain the EV battery economy, create jobs, and reduce importation of critical minerals. The policy is stated to anticipate challenges and supply chain demands, to ultimately build out a fully comprehensive approach for a net-zero carbon future.

Source: Automotive News, Business Wire, Ambarella

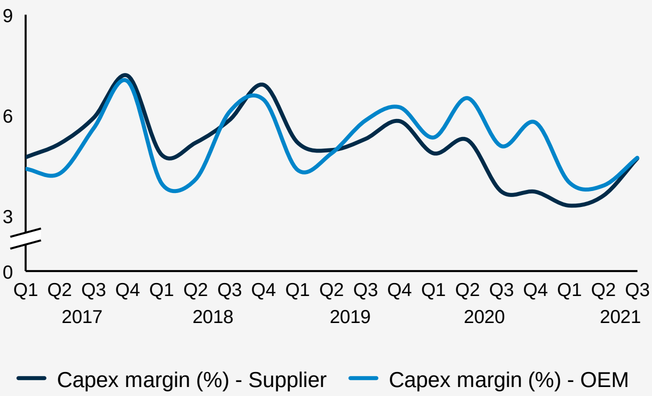
KPIs: automotive performance update

- This industry snapshot of financial KPIs compares the quarterly published results of 20 OEM and 70 automotive suppliers since 2017.
- After the recovery of Working Capital KPIs from the Corona peak, the supplier's figures are again increasing, especially the days inventory outstanding (DIO) which probably is triggered by the fact that suppliers try to overcome supply chain issues by increasing safety stock. On OEM side such development is not visible.
- Recovery of the equity ratios continues on both sides after the dip in Q3/Q4 2020.
- Also the Capex margin of the suppliers started to increase after a historic low in Q1 2021 achieving a comparable level as the OEM's.

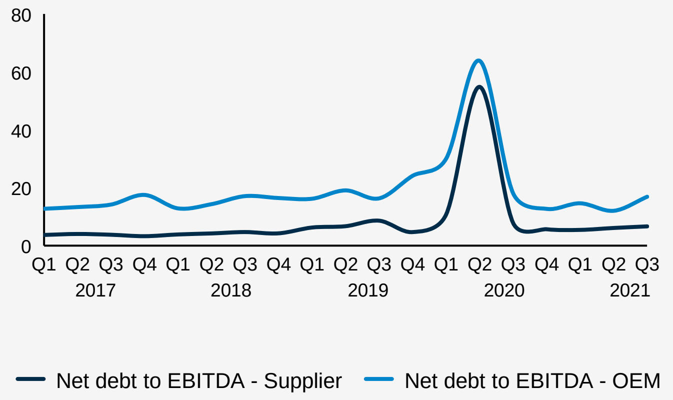
EBITDA margin (%) – Supplier vs. OEM



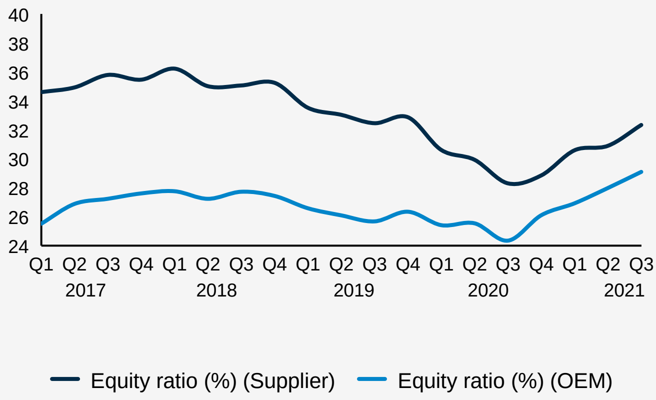
Capex margin (%) – Supplier vs. OEM



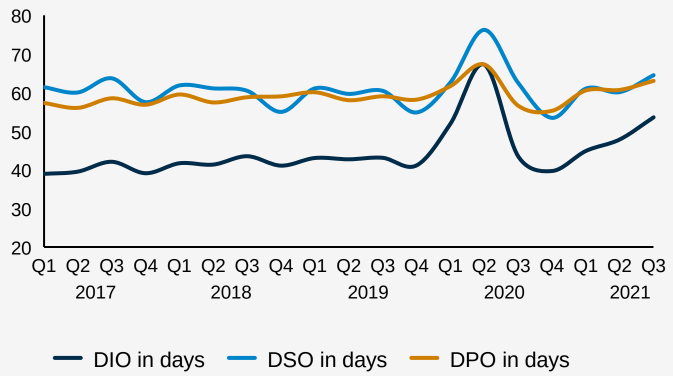
Net debt to EBITDA ratio – Supplier vs. OEM



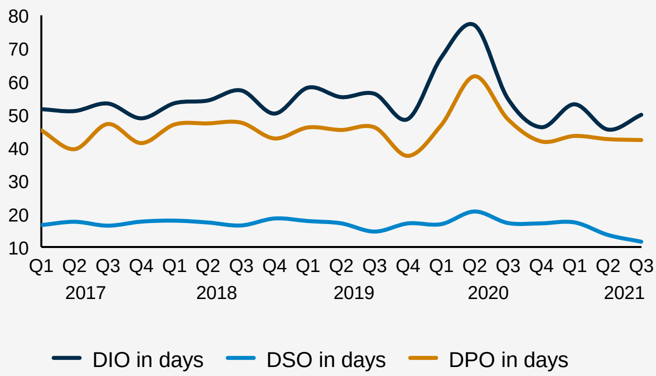
Equity ratio (%) – Supplier vs. OEM



Quarterly WC KPIs in days – Supplier



Quarterly WC KPIs in days – OEM



Source: Company Information, A&M analysis

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