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FROM THE INSIDE OUT

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Automotive Suppliers: Adapting to Technological Disruption

Revolution in the auto industry: How can suppliers get ready for the future?

The auto industry is at the start of the biggest disruption in its history: electric vehicles will replace the internal combustion engine, autonomous vehicles will replace drivers and shared ownership and ride-hailing will replace private cars. As carmakers race to keep up with these profound changes, suppliers must be prepared to significantly streamline their operations to maximise available cash for investing in new technologies and product lines.

The move to electric, autonomous and shared vehicles has been driven by environmental regulation to control emissions, changing consumer behaviour and advances in battery technology and artificial intelligence (AI). However, the speed of change will be driven primarily by regulation rather than technology and this is likely to vary from country to country, so car makers and suppliers must have flexible plans in place to adapt accordingly. Differences already exist: for example using Uber to hail a ride is commonplace in U.S. cities but relatively rare in Germany, where the service has to operate under the same rules as licensed taxi companies.

In China, the world's biggest car market, the government is aiming to increase electric vehicle sales to 2 million a year by 2020, and is expected to bring in a complete ban on sales of fossil-fuel powered cars by 2040, a goal shared by the UK and France. Norway and the Netherlands aim to stop selling fossil fuel vehicles by 2025. Meanwhile, autonomous vehicles are already being tested on the roads in U.S. states including Arizona, California and Pennsylvania.

Facing up to the future

"The critical point is how fast things will change," says Oliver Horlebein, Managing Director with Alvarez & Marsal in Munich. "Among suppliers, there will be a shake out and a significant number will not make it. The number one thing we're working on with companies is capital efficiency, so they have money available to buy into the transition."

For some automotive suppliers, these changes are an existential threat. There are 2,500 parts in an internal combustion engine (ICE) for example, but only 250 in an electric-powered one. However, it's not only powertrain suppliers who are under threat; interiors suppliers must be ready to meet very different requirements for shared vehicles, where the focus will be on the kind of low-cost, hard-wearing materials currently used in buses and trains. The shared car fleet market in Europe is expected to rise to 7.5 million by 2035, up from an estimated 370,000 currently [1].

Faced with this need to make urgent, capital-intensive changes to their business models, automotive suppliers are also contending with a slowdown in sales worldwide. Moody's cut its growth forecast for

[1] https://think.ing.com/uploads/reports/ING_-_Car_sharing_unlocked.pdf

auto sales in 2019 to 0.5 percent at the start of this year, after demand faltered in late 2018. Slowing economies across Europe and in China, plus the threat of U.S. import tariffs, have weighed on sales.

"The downturn has intensified the crisis for suppliers because the money they need for transformation is not easily available," says Mr. Horlebein. "There will be an upturn again, but the vehicles will be different."

How can suppliers respond?

"Companies must take action now to get the most out of their assets and maximize cash flow," he says. "Suppliers sit on a lot of assets that will no longer be required."

He gives the example of an A&M client producing machine tools to make internal combustion engines (ICEs). With virtually no significant new ICE projects starting, the company's orders fell by 40 percent last year.

"The average lifecycle of an engine is roughly 12 years, so that means new production line equipment I order today will be making the same ICEs for vehicles in the 2030s," he says. "Knowing what we know about the intentions of governments, that market is going to shrink."

Companies making such machinery must prepare to reduce capacity and should be planning now which sites will be impacted and how much of a headcount reduction they will need to make when the time comes. With the capital they have, they should buy in new applications such as 3D printing, battery cell manufacturing or lightweight, composite material processing.

Companies making components for the whole powertrain around an ICE must face up to the significant reduction in complexity that will happen when a battery-powered engine replaces the ICE. Many components including the gearbox will become obsolete. These companies must also plan for how they will reduce manufacturing capacity and headcount and consider how best to invest their capital. That could be leading consolidation and standardisation through mergers and acquisitions or becoming an assembler and supplier of electric powertrains.

"A&M is also working with automotive suppliers to help them form alliances and joint ventures," says Mr. Horlebein. "These steps are necessary in order to pool their spending power and accommodate the shortage of skills in electric and autonomous vehicles," he adds.

"Some of the investments required will be huge and it's very likely that suppliers will have to join forces in order to have the resources," says Mr. Horlebein.

Value is moving

Of course, not all suppliers need to reduce capacity – vehicles will contain more electronics, software and sensors, and these companies have an opportunity to increase the number of components they supply to carmakers. Once autonomous vehicles become the reality, cars will no longer be built around what a driver needs, and on-board entertainment will become much more important.

However, there is no room for complacency – electronics suppliers must optimize the capital they have to make major investments in these areas and define what kinds of companies they need to work with or buy to generate economies of scale, including partners from outside the traditional auto supply chain.

Across the board, automotive suppliers must make their operations as efficient as possible and take tough decisions on how they will allocate capital, to be prepared for the coming transformation of the industry.

"There's not going to be a sudden good news story that says 'everything is going to stay the way it has always been'," says Mr. Horlebein. "Even though it's not 100 percent clear at what pace these changes will happen because it will be driven by regulation, companies have to be ultra-responsive – and need to start their transformation now."

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