AIRA Journal

Volume 32 No. 3

WHAT'S INSIDE

AUTOMOTIVE INDUSTRY SLOWDOWN AND RESPONSES BY SUPPLIERS[1]

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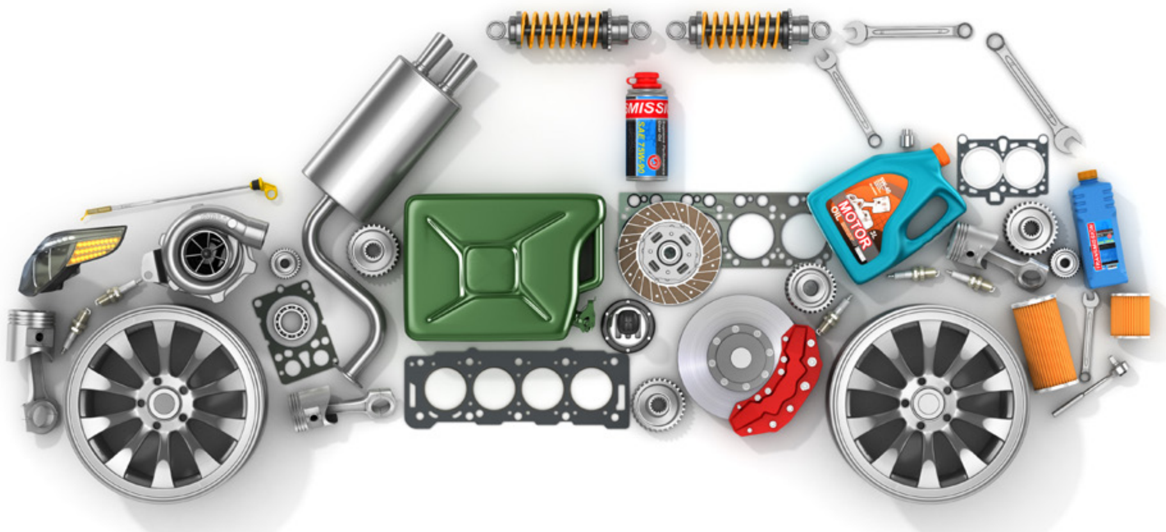

Introduction

It's been quite a ride for the automotive industry. Automakers and suppliers have enjoyed more than 10 years of steady growth since the Great Recession of 2007–2008 and recently completed an unprecedented four years of sales of 17 million or more units in the United States. As the U.S. entered its longest economic expansion in history this year, unemployment rates have declined to near historic lows, boosting the purchasing power and confidence of consumers. However, other macroeconomic and industry factors are casting doubt on the next chapter.

In one of the largest sales rebounds experienced by the industry since the Depression in the 1930s, consumers fueled the growth and the automakers were there to offer them exciting new products. The consumers took advantage of higher employment levels, growing income and persistently low interest rates — even 0% loan offers for new vehicles — to relieve pent up demand from last decade's recession.

Fierce competition by the automakers helped feed that demand as products improved and the technology inside those products was appreciated by the consumers. The success of the automakers allowed suppliers to build capital and helped shape the next chapter facing the industry. What effect will this pending downturn have on fundamental changes in the industry, and specifically on automotive parts suppliers?

Here we are in 2019, and sales are heading south, at least for the short term. The industry is facing pressures: sales and production are slowing; technology is transforming the industry; capital investment requirements are straining operational planning; and macroeconomic headwinds from trade agreements, signals from the bond markets, regulatory environments and an uncertainty from domestic and global economic slowdown all threaten to force action by the industry.

Longer term, big emerging trends in transportation mean the industry must continuously innovate, and capital planning is vitally important. Consider just a few trends: how people move from point A to point B is changing in previously unfathomable ways. Whether it's autonomous vehicles, emerging subscription car services (why own when you can subscribe? Gen Z wonders) or the way everything from refrigerators to vehicles now connects us with the internet, the industry faces unprecedented opportunities.

Automakers and suppliers face both short-term and long-term challenges, and for those well-positioned to

1 This article was produced with research and support from the A&M Insight Center. The author thanks others at A&M for research and market commentary that supported the article. See list of sources on page 28.

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take advantage of the big trends — electric vehicles being the chief catalyst for change — these challenges can become extraordinary opportunities.

Preparing for the changes in the industry requires a sober look at the present, a guide to help brace for a downturn and an understanding of how companies — and suppliers in particular — can navigate a distressed situation and transform themselves to meet the industry's needs in the future.

Industry Snapshot

Sales and Production Trending Down

The signs of a slowdown are becoming obvious, as new vehicle sales have peaked and automakers are enacting workforce reductions and adjustments to the production mix and capacity. Sales volume in the U.S. is forecasted to decline to 16.3 million units in 2019 and further decline to approximately 14.0 million in 2021–2022 before rebounding, according to Bank of America Merrill Lynch Global Research (BAML) (Exhibit 1). This would cause substantial issues for an industry that produces low margins, has a fixed cost structure and requires significant capital for product, engine development and technology.

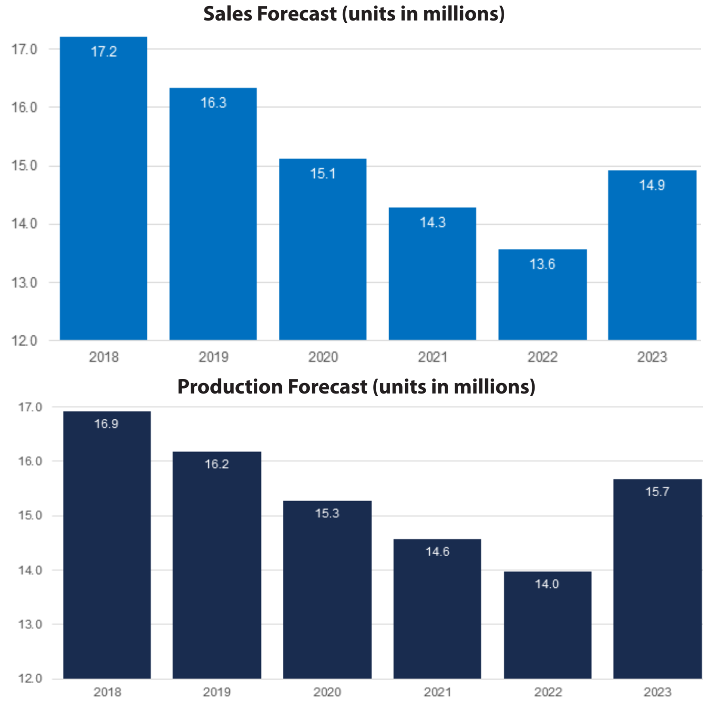
Two of the factors driving the slowdown in volumes are consumer choices and new vehicle affordability. Costs for product technology coupled with consumers' raging demand for truck and SUV vehicles over cars is causing higher price tags for new vehicles.

For consumers, the ability to absorb higher prices may be waning. Automakers anticipate a bubble effect in three years, as a high volume of vehicles come off lease and flood the used market, driving down industry pricing. As the volume of used vehicles grows, trade-in values decline, which will influence production and sales of new vehicles as consumers will have to finance more of the final price tag.

Consumers looking to trade in a vehicle may find they owe more than it's worth. That potential for negative equity means they'll look for cheaper alternatives, such as lower trim levels, or even forego new purchases altogether, opting instead for a late-model or certified used vehicle.

Anticipating a change in the weather for the industry, automakers and suppliers have begun to take actions on their cost structure to preserve margin and liquidity with the pending downturn. In 2018, many automakers announced substantial adjustments to their production schedule to manage inventory and prepare for softening demand. For example, General Motors stated it would close three plants and stop building the Chevy Impala and Cadillac XTS sedans. Ford Motor Company revealed it will have reduced 7,000 salaried employees, or 10% of its salaried workforce, by September 2019 and plans

Exhibit 1: Sales and Production Will Decline Before Rebounding in 2023



Source: WardsAuto, BAML Global Research estimates – report dated January 2019

to phase out production of most of the cars it sells in North America (its iconic Mustang and another future vehicle will remain in the portfolio). Finally, Fiat Chrysler Automobiles (FCA) is extending downtime at its plants to better align its production with sales and recently sold its automotive components division to add to its capital reserves.

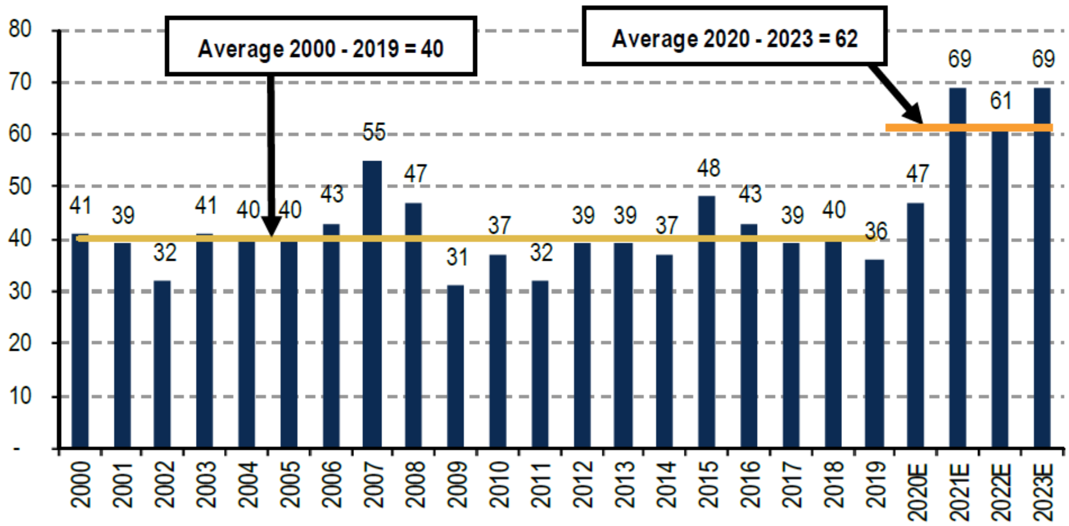
Another major tactic in the industry is seen in automakers' acceleration of the product cycle to maintain or grow market share. Companies are forecasted to launch an average of 62 new vehicles annually from 2020 to 2023, compared with an average annual rate of 40 new units over the past 20 years (Exhibit 2). From 2020 to 2023, the industry will replace 79% of its products, according to forecasts from BAML. It is noteworthy that more than 70% of new vehicles in the pipeline are either trucks or crossovers.

For the suppliers, the faster replacement rate will add pressure, especially as they face production demands to reliably manufacture new products coupled with uncertain timing and levels of demand from the automakers.

Technology and Realignment Require Heavy Investments

A significant challenge facing executives and directors in the boardroom is the pace of technological change required to satisfy consumers' demands. The industry continuously invests in technology, providing an incremental return in the short term; however, the

Exhibit 2: New U.S. Product Launches Reflect Accelerating Product Cycle



Source: BAML Global Research – report dated June 2019

investment is massive and necessary for long-term returns on investment for fully autonomous and 100% electric vehicles.

Anticipated future returns have attracted companies from beyond the traditional automotive industry due to real prospects for growth in their respective sectors. Apple, Google, Uber and Samsung lead the list of well-capitalized non-industry organizations that see advantages to autonomous deliveries, ride sharing, and vehicle connectivity and mobility, among others.

The following discussion highlights three key technologies:

- **Autonomous vehicles –** Technology which allows for driverless operation could increase the demand for those applications in many areas beyond ride sharing and product delivery. Therefore, automakers expect their investments to pay off in the long term. Part of that payoff includes greater efficiencies in travel and improved travel speed, two factors anticipated to drive future demand. Additionally, automakers must address consumer safety concerns, as well as a lack of standardized infrastructure to operate an effective autonomous fleet. In the meantime, the lack of return on autonomous vehicle investment in the short term will be a drag on the industry.
- **Electric vehicles** – Another technological catalyst, fully electric vehicles, is likely to take years for consumers to completely adopt but seems inevitable. The cost to manufacture an electric vehicle is currently higher than traditional vehicles based on the components but is expected to decrease over time, making them more and more attractive to the marketplace. That tipping point, according to BAML, will likely be in the mid-2020s as the total cost of electric vehicles will be equivalent to the total cost of traditional internal combustion engine powered vehicles. Today, the material costs of an electric vehicle are estimated at $33,600, more than double the $14,500 average cost of components in an internal combustion engine powered vehicle.

  Led by China, the U.S. and Norway, the global electric vehicle fleet exceeded 5 million units in 2018, nearly double the 2 million units from the previous year. Automakers have pledged higher production of electric vehicles in recent years. General Motors announced it will produce 20 new electric vehicles worldwide by 2023, and Volvo said it would only produce new vehicles with alternate powertrains after 2019, including five new electric vehicles by 2021. Volkswagen is making an aggressive bid to become the largest electric vehicle manufacturer among traditional automakers starting in 2020, when it intends to start selling a planned 22 million electric vehicles over the next decade under its goal of discontinuing internal combustion engines in its product portfolio.
- **Enhanced connectivity** – Finally, enhanced connectivity is a major influence in the industry and requires major research and development resources. Connectivity, in this sense, is how vehicles communicate to one another and to the internet. It forms the backbone of any efficient autonomous fleet in the future. However, significant investment in infrastructure to create the "smart road network," as BAML calls it, is vital for successful autonomous vehicle operation on scale, and there's little interest from the government sector so far to invest.

We can expect investments in these three technologies to impact earnings and cash flow across the industry in the near term. However, development over time will fuel demand and growth as consumers benefit from cost effectiveness and efficiencies which could produce an impressive economic stimulus. By far the most

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rapidly expanding technology is electric vehicles, which are expected to overtake internal combustion engine vehicles by 2037.

Macroeconomic Headwinds Produce an Uncertain Climate

Although the pillars of economic activity – gross domestic product, income growth, consumer confidence – are positive, market signals have moved from green to yellow. Ten years of growth continued through the second quarter of 2019 as the economy in the United States grew by 2.1%, down slightly from 3.1% in the first quarter.

The Federal Reserve, which was poised to raise rates at the end of 2018, cut rates for the first time since the financial crisis by a quarter point at the end of July, clearly signaling their concern with near-term activity and unsatisfying levels of inflation in the market. It followed with another quarter point reduction in September. Lower interest rates are a major factor in financing a large purchase such as a vehicle, which should provide some stimulus to the industry.

Similarly, the unemployment rate is near historic lows, and recent wage growth should fuel confidence of consumers to continue to purchase durable goods.

Finally, and most positively, is the pent-up demand for new vehicles. The average life of a vehicle on the road is nearly 12 years, much higher than the historical average. In comparison, the average life of a vehicle at the turn of this century was nine years, according to the U.S. Bureau of Transportation. Improving reliability has assisted with duration and life of vehicles, but at some point, vehicles wear out. The question then is whether consumers will purchase a new or used vehicle to replace it.

Going in the opposite direction, the stock market fell 800 points in mid-August as bond yields are signaling trouble ahead with the 10-year Treasury Bond declining below the two-year Treasury Bond ("the inverted yield curve") for the first time since 2007. Analysts consider this a key predictor of a pending economic recession.

Despite favorable economic conditions, the industry is facing headwinds that will negatively affect vehicle sales and production in the middle of the historic transformation of the industry, which may divert focus.

Additional influencing factors:

- **Raw materials** – From 2011 to 2016, the industry benefited from declining raw material inputs, as the cost of materials in the average vehicle fell by more than half to $2,000. Suppliers particularly benefited, since lower raw material costs increased margins. In 2018, the trend began to reverse and is expected to persist as a headwind through 2019 and possibly beyond. While still near historically low levels, raw material costs are now going in the wrong direction for the industry. Costs for steel, resin, plastics and other component materials have increased, with steel taking on the added burden of the trade war with China.
- **Trade policies** – The tension between countries that are intertwined with the supply chain is causing executives to evaluate their production footprint and long-term plans. Governmental policies and standards are a driving force in the sector. For example, the United States–Mexico–Canada Agreement (USMCA), signed in September 2018 to replace the North American Free Trade Agreement (NAFTA), will require more of a vehicle's parts to be made in North America for the vehicle to avoid tariffs. The USMCA will also require that 40% of motor vehicles be manufactured in facilities where workers earn at least $16 per hour. And since the agreement allows automotive workers in Mexico to form trade unions, manufacturing south of the border will become more expensive.[2]
- **Government regulation** – Meanwhile, higher energy efficiency regulations are putting pressure on the industry to respond. In the United States, regulators set a target of 54.5 miles per gallon (mpg) for a fleet-wide average by 2025, which compares to 25.0 mpg in 2017. While automakers support these targets, they also realize further innovation and change is required to achieve the targets. The Trump Administration aims to freeze mpg goals at the 2020 level and prevent California from setting its own, stricter mandates. If passed, the measure would provide some relief to automakers in the short term. In July 2019, four major automakers announced they reached a deal with the State of California to increase fuel efficiency standards.
- **Fuel prices** – Volatility in gas prices may affect consumers in a negative manner in the short term. For the past decade, consumers have enjoyed low gas prices and have opted for higher margin trucks and crossovers, and the automakers are predicting gas prices will remain at a low, sustainable level. If an event (i.e., geo-political) caused a dramatic increase in gas prices, that would divert disposable income to paying for gas and impact consumers' ability and appetite to purchase or lease a new vehicle. Separately, the automakers have made significant adjustments to their product portfolios, which means, if gas prices were to remain elevated for a long period of time, the consumer would have fewer options for smaller, more fuel-efficient vehicles.
- **Interest rates** – Consumers, buoyed by favorable interest rates, have been opting for higher-priced vehicles with longer-term loans. As the Federal

2 At the time of this publication, the USMCA had been passed by Mexico but was still pending ratification by the legislatures of the U.S. and Canada.

Reserve begins to reduce rates to counter the anticipated lower economic activity levels and global influences, this will provide stimulus to the industry and may push some consumers who are on the fence into local dealerships. In this historically low interest rate environment, automobile financing has been very favorable for consumers, so any change in the cost to finance would have negative effects on sales volume of new vehicles.

- **Intra-industry hurdles** – Challenges within the industry also threaten to slow growth. In general, the automotive industry produces low margins, has a fixed cost structure and requires significant capital for product development and technology. Product recalls and testing violations present challenges to the automakers and have caused a significant drain on resources and reputations over the past few years.

  In addition, customers are pressuring suppliers to reduce prices in the face of lower volume forecasts over the next few years. The automakers are enacting cost reduction programs and are concurrently demanding the same from the suppliers. Another indicator of softening demand is the increasing incentives for new vehicles offered by automakers. In August 2019, the industry reported an average incentive of $3,825 per vehicle, exceeding 10% of the total price of the vehicle.

- **Tariff uncertainty** – A final macroeconomic headwind facing the industry is the uncertain tariff environment prompted last year as the United States set off a trade war with various countries, including China, a significant player in the manufacturing industry in North American and an essential market for automakers based in the United States. While the Trump Administration earlier this year eased restrictions with China, the climate is volatile. Any implementation of tariffs will increase consumer prices for new vehicles, further lower sales volumes, impact U.S. GDP and raise the overall cost of vehicle ownership.

  So far in 2019, U.S.-sanctioned tariffs on China have driven up the cost of raw materials such as steel and aluminum. Continued negotiations between the U.S. and China may result in higher costs for other raw materials that will impact the industry.

Supplier Responses to the Industry's Challenges

In a distressed situation, a supplier can find relief by simultaneously taking actions on both the operational and financial side of their business. While the industry has experienced a good decade, below is a refresher of some typical tactics suppliers can deploy to counter the impacts of falling revenue, or if in distress, ways to conduct a restructuring to address many of the most disruptive challenges.

Tactics to Prepare or Shield Suppliers in a Downturn

Automotive suppliers have done well the past decade to bolster their financial health with steady earnings growth and a reduction in leverage. But based on the expected slowdown in the industry, now may be the time to work with the balance sheet to find additional liquidity and flexibility and make operational adjustments. The good news is that suppliers have several options to prepare for and react to declining revenues and margins.

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Exhibit 3: Financial Information for Hypothetical Mid-Market Supplier

Sales and Expenses (based on 250 production / sales days)

	Annual Total	Per Day
Sales	$500 million	$2.0 million
Cost of Goods Sold (COGS)	$425 million	$1.7 million
COGS Minus Labor Costs	$300 million	$1.2 million
Capital Expenditures and Debt Service	$75 million	

Selected Balance Sheet Amounts as of June 2019 (in $millions)

Total Assets (in millions)	$850	Total Liabilities and Equity	$850
Cash and Cash Equivalents	$50	Current Portion of L-T Debt	$75
Accounts Receivable, Production	$100	Accounts Payable	$50
Accounts Receivable, Tooling	$15	Long Term Debt	$225
Inventory	$100	Other Liabilities	$135
Property, Plant, Equipment, Net	$585	Equity	$365

Alvarez & Marsal, Illustrations

The automotive industry is a relatively low-margin, capital-consuming industry – fixed costs are high as a percentage of total costs, and based on the product turnover, demand for elevated amounts for tooling and equipment expenditures are significant. When suppliers work to strengthen their financials by trimming costs, it's important that they focus on two goals: cash conservation and providing as much liquidity as possible for the operational and commercial teams to resolve, or develop a plan to resolve, the issues.

Exhibit 3 presents illustrative financial information for a hypothetical mid-market supplier that will be used to demonstrate areas owners and operators should examine in order to find sources of incremental liquidity for the business.

As suppliers take steps to resolve some of the pressures, such as reduced production days and required capital expenditures and debt service, there are a few common ways to generate additional liquidity via the balance sheet. They include seeking avenues for increased credit, negotiating temporary changes in terms for accounts receivable and/or accounts payable, and encouraging equity contributions or investments in the business.

Following is a discussion of common ways to utilize the balance sheet to generate additional liquidity, using information from Exhibit 3 for illustration.

Borrowing or increased credit lines (using an ABL)

Our supplier has approximately $200 million of working capital assets, or accounts receivable and inventory. As this supplier does not already have an asset-based loan (ABL), they have a valuable option in front of them: they can utilize the saleable collateral on the balance sheet to offer coverage to lenders that will provide them credit. This is very common in this industry that allows the supplier to access funds to pay bills at very manageable interest rates. This would result in more leverage for the business but the market factors may require it, the debt is usually inexpensive since the loan is secured by collateral and the lender has the ability to exit when the value of the collateral no longer supports the borrowed amounts.

In a more pressing situation, seeking accommodations from an existing lender may provide temporary relief. However, suppliers should develop a comprehensive game plan before approaching lenders as any request will most likely prompt a strong reaction, straining the relationship between the parties.

Further tactics to extract liquidity (without an ABL)

- **Accounts receivable, production –** One of the ways our supplier can make the current assets work harder for the company is by negotiating a reduction in payment terms from their customer(s). It's a lever that quickly helps the supplier's liquidity situation. This straightforward request accelerates the payment cycle to the supplier and benefits cash flow. This usually involves a tough negotiation, depending on the supplier's perceived value to the customers. Negotiating will require clear communication and a sound game plan to manage the potentially negative consequences from customers who prefer the status quo. To illustrate the working capital benefit of renegotiated terms, our supplier in Exhibit 3 has an accounts receivable balance at the end of June 2019 of $100 million, and the current contractual payment terms are 45 days from receipt of the good or service. By implementing a five-day reduction in terms, the supplier would see incremental liquidity of approximately $10 million, or 5 x $2 million sales per day.

- **Accounts receivable, tooling** – Using a similar strategy, incremental liquidity can be achieved by requesting accelerated payments related to the tooling invoices. The tooling documentation must be approved by the customer's quality department, but once completed and the accommodation granted by the customer, the supplier can pay off the liabilities to the tooling vendor or for general corporate purposes.
- **Property, plant and equipment** – Asset sales are becoming more commonplace in the current environment to generate capital to pay off secured debt and provide financial relief for the business. Based on its current business plan, our illustrative supplier should be asking whether operating assets are being put to the best use and whether there are likely buyers for certain assets that will not be core to the long-term objectives.
- **Accounts payable, trade** – Just as suppliers can use accounts receivable to generate incremental liquidity, they can also renegotiate on the other side of the balance sheet — accounts payable. By getting an extension in the time to pay bills, suppliers can save cash. In our example, the supplier has an accounts payable balance at the end of June 2019 of $50 million with contractual payment terms set at 45 days from receipt of the good or service. By extending the terms by five days, the supplier will realize incremental liquidity for the business of approximately $6 million, or 5 x $1.2 million cost of goods sold (COGS), less labor costs, per day. This tactic is also difficult to negotiate and implement unless the supplier has a compelling reason and the vendors are in good financial shape. These negotiations typically involve extensive communication with vendors, so they have a full understanding of the reasoning behind the concessions and their duration.
- **Long term debt** – Suppliers may be able to seek accommodations on their long-term debt, such as requesting a forbearance or asking for a deferment of quarterly or monthly debt service.
- **Equity** – Finally, owners of the supplier can be another source of funding. In a distressed condition, however, suppliers will need a concise plan from the management team that describes how all other avenues have been explored for additional liquidity and that a solid recovery plan has been developed so any capital infusion is not wasted. If the situation is bleak, the owners may be unwilling to continue investing in the business and have the management team seek other options.

Arming themselves with key tactics and a solid plan to return to optimal performance can help suppliers weather short-term downturns in the economy or industry. Choosing the best option depends on the supplier's immediate- and medium-term needs. The time for action is now.

What to Expect in Restructuring for a Supplier in Distress

The supply chain in this industry is well defined and the automakers depend upon a network of suppliers for goods and service (Exhibit 4). This framework is like other industries where the supply chain is vertical and the success of a customer depends on the success and performance of their suppliers.

For suppliers experiencing distress, building a thoughtful plan to relieve pressure and directly address their customers' demands can mean the difference between failing and thriving during tough times. When the winds of misfortune blow, leadership within the supplier's organization should work with the equity owners to map out a strategy before approaching customers and other constituencies. With appropriate preparation, suppliers can guard against the tendency to battle on numerous fronts when difficult decisions are required.

What does the restructuring process look like for suppliers in the automotive industry? The following analysis may serve as a playbook to help suppliers understand the typical steps in restructuring and the options available to them.

When the operational and financial initiatives discussed above fail to resolve the issues for suppliers, it's time to develop the plan and reach out to others for help. One of the key documents in a distressed situation is a short-term agreement referred to as an accommodation agreement. This document is heavily negotiated and details terms (or accommodations) among the four major stakeholders: the supplier, customer(s), lender and owner(s).

This agreement works as a bridge to carry the stakeholders from the current situation to a resolution. Establishing terms that will be conducive for a favorable outcome is crucial, so finding experts that are experienced with these agreements is important to

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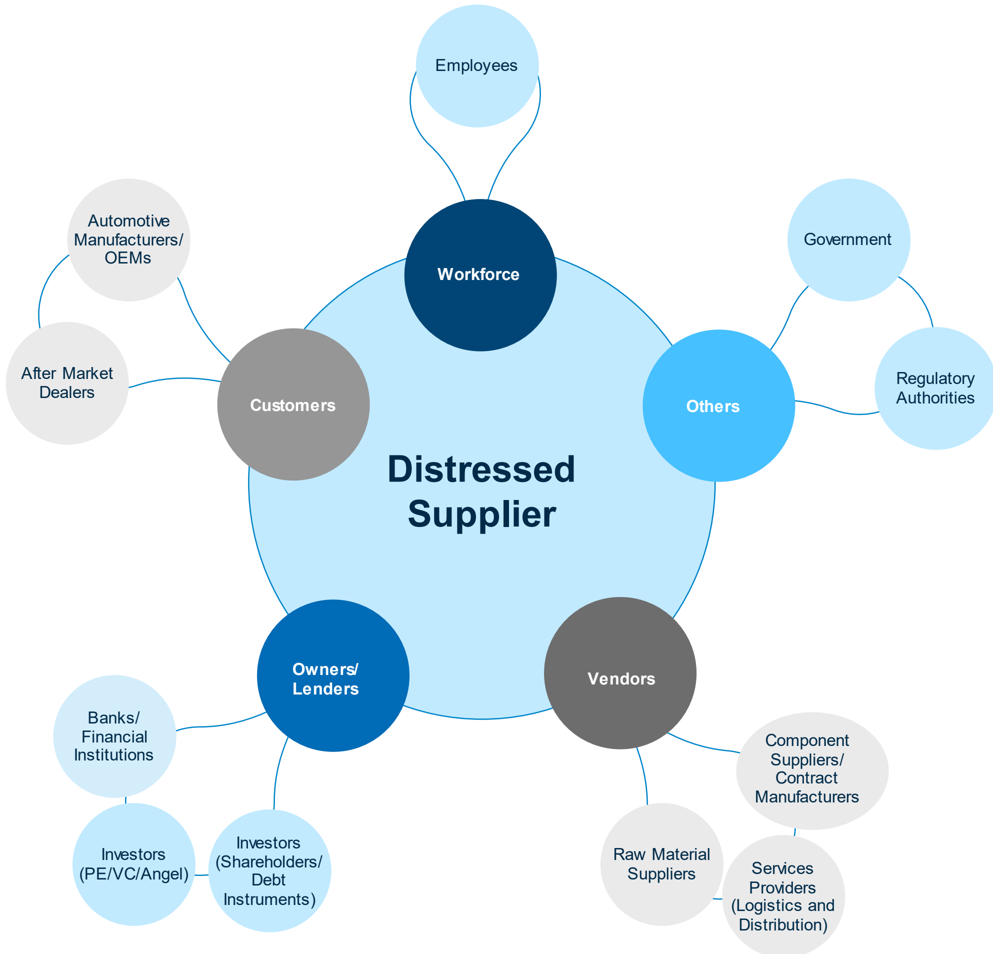
Exhibit 4: Supplier Restructurings Involve Many Stakeholders



help suppliers properly evaluate the terms and overall agreement. Below are some of the most common terms of an accommodation agreement.

Accommodations suppliers may make to the customer(s)

During times of distress and a restructuring process, suppliers will need to assure stakeholders that they can continue to perform under certain conditions. Typically, the supplier agrees to:

- Commit to produce parts, including service parts, and to develop a parts bank (inventory) to provide additional supply, if requested by the customers;
- Grant access to customer(s) that allows them to effectively operate the business and production facilities if certain operational disruptions occur, usually a separate agreement called an access agreement;
- Allow additional oversight and access to information by customers to work through the process;
- Consent to allow customer(s) to evaluate any buyer of the distressed supplier, if the supplier agrees to be sold; and
- Make other accommodations for customer(s), such as providing a purchase option for the machinery and equipment and inventory, which allows the customer to get access to the operating assets to maintain supply.

Accommodations lenders may make to the supplier

In any restructuring process, suppliers need to give lenders assurance the plan will result in improved operations or a path forward to resolve the situation. Accommodations by lenders can help suppliers with required liquidity to provide additional runway. Typical accommodations from lenders include:

- Adjusting the terms of the credit agreement, including higher advance rates on accounts receivable and inventory for ABL lenders to allow the supplier to borrow more, and change economic terms for other debt to provide additional liquidity for the supplier on a short-term basis;
- Committing to fund a reasonably acceptable operating budget and expect that the supplier will coordinate with the lender's workout group or outside advisors;
- Developing a short-term forbearance agreement with terms acceptable to the parties so that the lender does not make a collateral call or tighten

access to liquidity before the final restructuring plan is developed; and

- Entering into an access agreement giving customer(s) a right to operate the supplier's facilities if production issues arise and an option to purchase the machinery, equipment and inventory at a negotiated amount if there is a default.

Accommodations customer(s) may make to the supplier

Terms from the customer(s) to the supplier will depend upon the supplier's unique situation and often change during negotiation. Typical terms from customer(s) include both operational and financial agreements that must work hand-in-hand for a successful resolution of the situation.

Operational accommodations

- Prohibit customers from sourcing the product or service elsewhere, which provides stability to the supplier and usually comes with conditions on performance and milestones;
- Utilize suppliers' understanding of their own underperforming programs or parts to allow coordination with the customer to resource the work if negotiations fail on financial accommodations such as price increases (see below), strengthening the financial outlook for the supplier;
- Employ the customers' operational experts to help resolve a supplier's production problem or to make a change in tooling design to stabilize production;
- Endorse plans to move supplier production sites and pay for the transportation costs, which can help reduce costs (e.g., from a smaller production footprint); and
- Establish an exit strategy for the customer(s) if the process breaks down, which may include a coordinated transfer of production of parts, tooling, or equipment to another supplier to protect the customer's supply.

Financial accommodations

Working in conjunction with the operational improvement plan, financial accommodations offer suppliers numerous options to help bridge the gap between a distressed situation to the ultimate resolution. Automakers and other customers are focused on avoiding supply disruptions and will insert their own operational and financial teams into the situation if there is a threat or potential threat to their supply. Financial accommodations offer the ability to stabilize a distressed situation while the parties negotiate and develop a plan to resolve the situation. However, suppliers must be aware of accommodations from customers that come with conditions that may be onerous for the supplier and could cloud the future of the supplier, based on future sourcing direction from the customers.

- *Accelerated payments* – One of the most common ways to provide immediate liquidity to a supplier is for a customer to accelerate payments for production parts or tooling. This action fast tracks cash to the supplier to pay bills and may help calm the supplier's vendors, but the duration of this accommodation is usually temporary. This action is muted if the supplier is managing liquidity through an ABL. In that case, the accelerated payments provide marginal benefit since the supplier is already borrowing on the accounts receivable from their customers. In general, accelerating payments is a convenient accommodation as it is only a working capital impact to the customers and doesn't affect earnings.
- *Resolution of unsettled commercial issues* – Another way to improve liquidity for suppliers is to resolve their unsettled commercial issues with their customers. Those issues may include unpaid production or tooling invoices or warranty disputes. Putting the resolution on a fast track is a common activity in the restructuring process with suppliers.
- *Limitation of setoff rights* – Suppliers can seek liquidity support by having customers agree to limit any setoff rights, such as costs incurred because of expedited shipping, quality defects or product recalls. Based on the standard agreements, customers can reduce, or "setoff," costs incurred by them on behalf of the supplier and deduct those amounts from payments to the supplier. If the customers agree to limit the setoff to 2 to 5% of the supplier's accounts receivable, this will avoid a bad situation becoming worse because of a rapid drain on liquidity.
- *Other working capital options* – In addition to limiting setoff rights, suppliers can look to other working capital options that are beneficial. For example, customers can reimburse suppliers for research, development, or engineering costs in monthly or quarterly installments rather than amortized in the price of the part over the duration of the program. In cases where there's a disruption of supply or a problem with delivering new tooling in a timely fashion, automakers can make direct installment payments to the production or tooling vendors.
- *Pricing adjustments* – One of the more difficult accommodations to achieve is pricing

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adjustments. Customers are usually averse to higher prices for production parts, but if successful, it could result in incremental liquidity for the supplier. Increasing production parts prices would provide incremental liquidity. Reaching agreement on these terms depends upon the suppliers' position in the market and what alternatives are available to the customers.

- *Loans or other participation agreements* – Finally, customers may agree to make loans to suppliers or establish other forms of participation agreements with lenders in more challenging situations to protect supply. This is typically a bridge to a resolution of the situation such as a sale or transfer of business, since customers prefer not to extend loans to their supply chain.

Conclusion

The market indicators for the automotive industry are flashing a cautionary yellow light right now. With weakening new vehicle demand, diminished affordability, various headwinds and intra-industry pressures, suppliers should look for ways to strengthen operations and implement liquidity measures to conserve cash and prepare for the downturn in order to be well-positioned for the next chapter.

If market forecasts are accurate, and an industry slowdown gains momentum, we can expect an elevated level of restructuring activity from suppliers. For suppliers in distress and facing challenges like production volume declines, product launch issues, unforeseen recalls, tension with customers and lending difficulties, understanding their options in a restructuring context can be beneficial. Fortunately, the restructuring process is well-defined for this industry and offers many options to help a supplier meet the demands of all its stakeholders – from customers and vendors to lenders and owners and to its workforce.

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