

viewpoint

SUPPLIERS AT RISK

The sharp slump in vehicle sales across Europe is having a double impact on auto industry suppliers, which can typically account for about half a vehicle's value. Demand for new cars has been running about 20% below last year's level. But because the downturn occurred so quickly, vehicle manufacturers have had to reduce production much more sharply, by as much as 40% in the short term, to help bring inventories back into balance. As a result, suppliers are struggling with conditions that are much more severe than those facing carmakers.



Eric Wallbank

Eric Wallbank, director for Ernst & Young's European Automotive Team in London, comments on the situation and what suppliers can do about it.

How did the supplier crisis develop?

It began before the recent economic crisis as European supplier companies struggled with high raw material costs and extraordinarily strong pressure on piece price from vehicle manufacturers. By the middle of last year, many suppliers were already weakened financially, and that was before the market collapsed.

Car manufacturers began reducing production toward the end of 2008, but the impact wasn't felt among suppliers until the beginning of this year. Now those companies are trying to reduce costs fast enough to survive until vehicle production begins to match actual demand again and subsequently pick up as the market improves. The challenge is that we still don't know where the bottom will be. That makes it very difficult to tell when the production adjustment among the car manufacturers will be completed.

How big is the problem?

The car companies all have risk management programs that identify suppliers at risk, and for some the number of at-risk suppliers has probably gone up by a factor of 10 to 20 in recent months.

What will happen next?

It will be survival of the fittest, and in any given sub-sector of the supply industry the weaker players will fail. But components must be made somewhere, so competitors will pick up those contracts. Suppliers have to be stronger than the weaker players in their sub-sector. We are going to see more carmakers being forced to change suppliers and move tooling this year.

How can distressed suppliers find help?

Suppliers are often nervous about telling customers they're in trouble, because they think a carmaker may use it as a reason to move the business. But manufacturers are becoming more accustomed to this issue and are getting better at responding. Some will help because it's cheaper than finding a new source. Unfortunately, many are short on cash themselves and can't help. Many suppliers are approaching manufacturers for price increases, and manufacturers are looking hard at these to see the degree to which they might be justified.

Which suppliers are at greatest risk?

In general, the companies with the most problems are those with high levels of debt, including private equity firms that have made leveraged acquisitions, and who are finding it more difficult to refinance. Some are breaking covenants in their banking agreements, at which point their lenders may take action. Smaller companies seem to be at higher risk. They tend to have smaller contracts and fewer customers, and their management may not be as experienced in crisis management.

What is your advice to suppliers?

1. You need strong cash management. It is critical to get a strong grip on the cash position of the business. A good forecasting system is essential in order to understand, as well as possible, the likely revenue line. Take all possible action to reduce costs and so lower your break-even point.

2. Have open discussions with your customers about volumes and the profitability of your contracts. Many manufacturers are willing to listen to a supplier with genuine distress on a particular contract. It is true that some manufacturers will react negatively. But given the number of suppliers in distress, few carmakers will move a contract lightly.

3. Look at the upside. Consider which competitors are at risk of failure. There may be an opportunity to go to a customer and declare your willingness to help if another supplier fails.

4. It's critical to continue to invest in innovation. Companies that can do that increase their chances of winning the next contract or vehicle program. Companies with a unique specialization are often stronger and more likely to survive.

5. Make scenario plans based on "what-if" options. Determine your contingencies now. The threat will be greatest between now and the end of the summer.

To learn more about how Ernst & Young can help suppliers in these difficult times, please contact Eric Wallbank at +44 (0) 207 951 0352 or ewallbank@uk.ey.com.

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