VIEWPOINT REPRINT

WHAT LIES AHEAD FOR EUROPE'S AUTOMOTIVE INDUSTRY?

Virtually everyone expects car sales to decline in western Europe this year, even if the region's major national markets extend scrappage programs. Last year those programs generated substantial additional sales. But they also pulled forward orders that would have occurred in 2010. With fewer, if any, incentives likely to continue beyond the first quarter, car sales in Europe are likely to drop by at least 10% from last year's levels.

Peter Fuss

How will the European automotive market develop this year and beyond? Peter Fuß, Partner at Ernst & Young's Global Automotive Center in Stuttgart, comments.

What is the health of the Europe automotive industry coming into 2010?

Last year was unique because of the scrappage programs in all major markets. These incentives resulted in total new-car sales of 14.5 million, only 1.6% below 2008 in spite of the recession. Sales were up more than 23% in Germany and nearly 11% in France.

But incentives distorted the market. They helped carmakers who specialize in small vehicles but had virtually no impact on luxury-car producers. Sales soared in western Europe, where scrappage programs were common, but they plunged in eastern Europe where incentives were rare.

This year luxury car makers that didn't benefit from last year's scrappage programs are already seeing stronger sales as corporate leasing begins to recover. Fleet sales are up significantly. This is having a major impact on suppliers, because margins are significantly greater on components for high-end vehicles.

However, many second-tier suppliers will continue to suffer. Their volume is down as much as 50%, and an increasing number are distressed. Cash flow is a critical issue, and more bankruptcies are very likely. With no working capital available, these suppliers have a very limited ability to respond to expanding vehicle production schedules.

How will this affect the product mix?

Many OEMs are trying to broaden their lineups and leverage their product development investments by using fewer platforms, expanding into more markets and looking for economies of scale. There will be more partnerships formed to help achieve these goals, and more mergers appear likely. We anticipate extremely strong competition in the premium segment. Over time there will be more affluent people in the world, and that means more demand for high-end vehicles. This trend makes the premium segment very important. It's also the only segment where buyers are willing to pay a premium for the newest technology.

What about Europe's overcapacity issue?

There will be reductions, but it is not yet clear when or in what form they will take. In general, OEMs appear more likely to reduce output across most or all plants rather than shut down a few facilities entirely. Over the past 10 years the industry boosted capacity by building new plants in eastern Europe. The assumption was that markets there would grow enough to justify the expansion. Consequently, the addition of new plants in the east had little impact on existing facilities in the west.

Now the industry faces another two or three years before volumes return to 2008 levels. What happens in Russia will be very important. It has the potential to become a 5-million-vehicle market and could absorb some of the industry's overcapacity.

The biggest challenge is that Europe is a huge market divided by regional thinking. The industry as a whole recognizes its capacity problem, but no country wants to be the one to take unilateral action and the job losses that would result. Until this quandary is resolved, Europe's ability to compete with other regions where capacity is better balanced will continue to erode.

The good news is that many automotive suppliers used last year's lull in sales to reorganize their processes and become leaner. Much of this effort required little or no cost. The suppliers that made these adjustments could see a sharp improvement in profitability this year, even without a big upturn in vehicle production.

How will car sales evolve this year?

There may be mild growth in the second half of the year, but it very unlikely to reach last year's full-year volume. The keys to success will be innovation and differentiation, and not just in "green" technologies. You will be able to determine which OEMs are on the right track by how much they spend in this area.

The builders of premium vehicles will gain share this year, and the producers of small, inexpensive cars will lose share. Premium carmakers are merging the public's desire for smaller cars with the luxury features formerly offered only in higher-end models. This is a competitive advantage for them, because they can apply their well-established image of quality and exclusivity to smaller cars. It will be considerably more difficult for traditional makers of lower-priced vehicles to convince their customers to pay more for upscale models. Ernst & Young can help OEMs and automotive suppliers adjust their current business model to take advantage of the future opportunities (i.e., investments in advanced powertrain through joint ventures with non-automotive companies) in this challenging market.

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