Fast forward after the Covid-19 crisis. How suppliers can successfully adjust their strategies for the future

LAZARD

Roland Berger

Automotive suppliers had already faced a deteriorating market situation in 2019. But the Covid-19 pandemic made a race to the bottom out of it. In light of the crisis, suppliers saw their margins drop sharply in the first half of 2020.

This development comes on top of the technological change the automotive industry has to deal with. Being on the brink of a new era of mobility, automotive suppliers need capital to prepare for electric mobility, autonomous driving and the digitalization of cars.

Handling these contrasting challenges requires suppliers to adjust their strategies, keep access to capital and reduce their debt levels, which increased significantly in 2020.

Looking back to the financial crisis of 2008/ 2009, it becomes obvious that times of market disruption are also windows of opportunities. With our 'Winners' Framework analysis we extracted four key characteristics of companies that were exceptionally successful in the last decade: 'business leadership', 'strategic coherence', 'size and financial position' as well as a 'proven ability to execute'.

Cover image gaspr13/Gettyimages

The current crisis reinforces suppliers' need for strategic transformation

After already seeing deteriorating margins in 2019, automotive production volumes collapsed due to Covid-19, bringing margins to historic lows and raising debt leverage levels of automotive suppliers to new highs in H1/2020. Even China's relatively quick recovery from the Covid-19 shock could not compensate for the global volume losses. As a consequence, almost all suppliers are forced to rethink their strategies and restructure their legacy business. Pre-crisis peak volume levels are unlikely to be reached before 2026.

But waiting for the market situation to improve is not a viable strategy. This is because the long-term trends shaping the future of automotive and mobility remain unchanged. Technological transformation keeps putting pressure on the industry. Besides dealing with the crisis, product portfolios need to be adjusted for electric mobility, autonomous driving and the digitalization of cars.

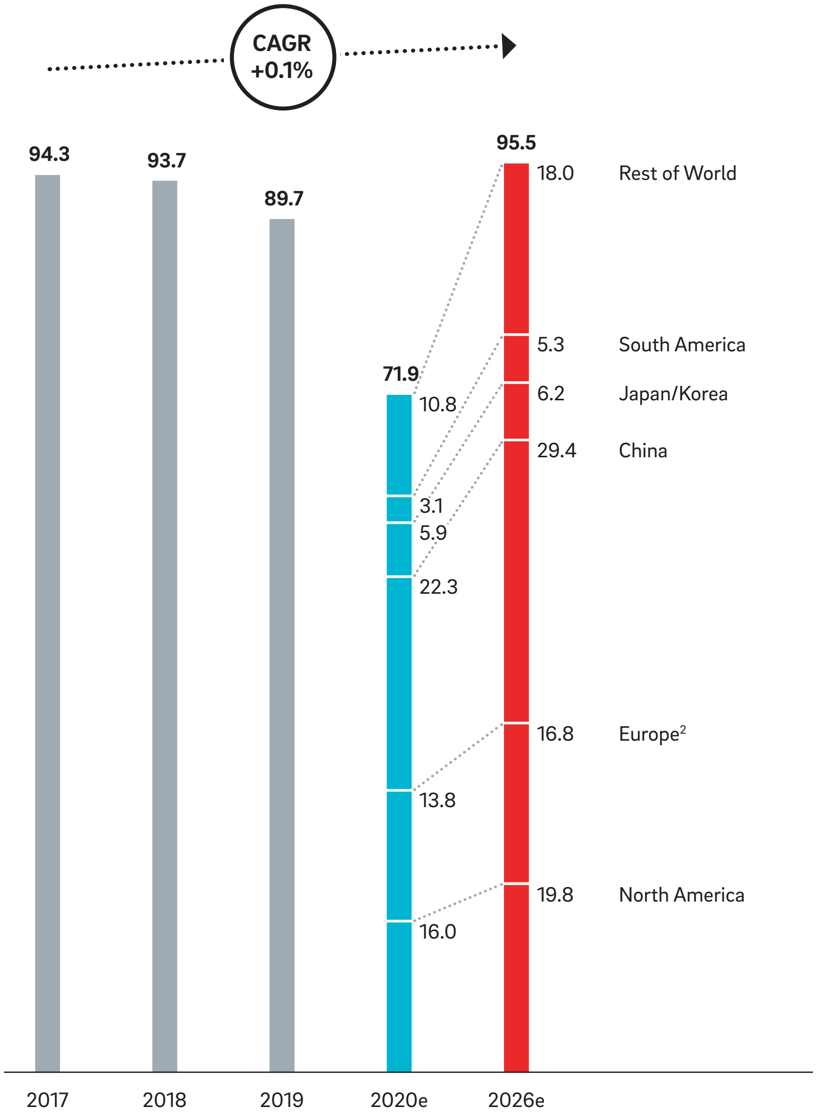
However, the Covid-19 crisis can also be a window of opportunity for automotive suppliers. It is a chance to reposition themselves and emerge stronger from the crisis. Based on our analysis of automotive suppliers' recovery after the global financial crisis we demonstrate that success is determined by a holistic strategy comprising market leadership, financial strength and result driven execution. These are characteristics that all exceptionally successful suppliers over the last 10 years have in common.

Looking forward, safeguarding financial flexibility and shaping a successful business model for this decade are key tasks for automotive suppliers. In other words, walking a tightrope between restructuring and repositioning.

To navigate these challenging times we developed our Triple Transformation Framework. The framework helps companies structure suitable measures along the three dimensions Position, Perform and Progress, supporting the whole transformation process towards becoming a good corporate citizen.

The global automotive market has already been shrinking since 2017

Global light vehicle sales volume[1], 2017-2020 and outlook 2026
[m units]



[1] Incl. light commercial vehicles [2] Excluding CIS and Turkey

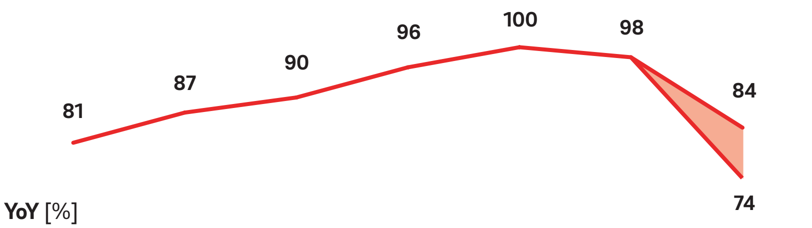
Source: IHS LV Sales Report 09/2020, Roland Berger/Lazard

Automotive suppliers' revenues peaked in 2018 and dropped steeply in the wake of Covid-19

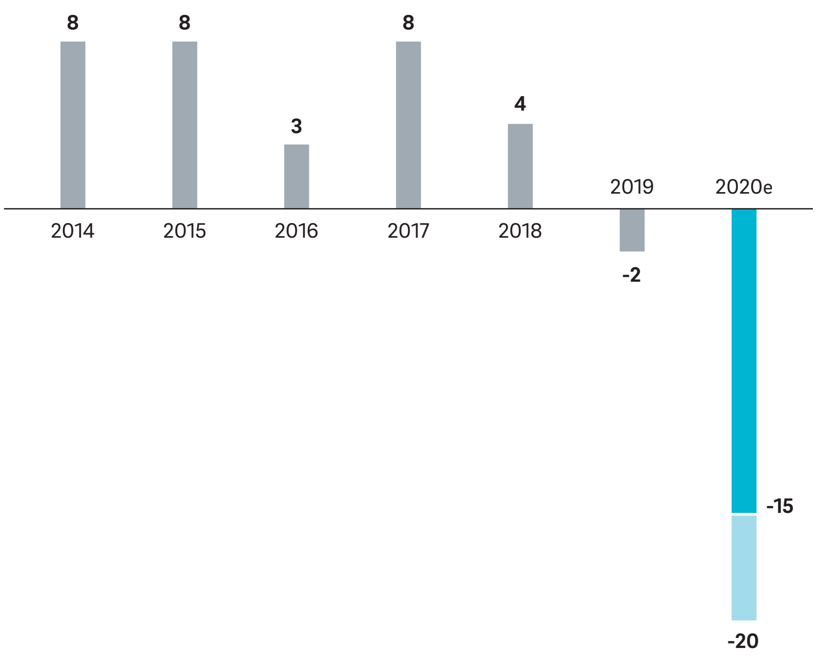
Globally, suppliers are expected to face a sales slump of -15% to -20% in 2020 in comparison to last year. However, the regional impact of Covid-19 differs significantly. Europe's and North America's higher dependency on exports and global supply chains made the regions more vulnerable to Covid-19, bringing H1/2020 revenues down by a quarter compared to pre-crisis levels. China benefits from a stronger local market and an efficiently handled lockdown period, which leaves suppliers in a better position with only a 10% decline compared to pre-crisis volumes.

Revenue development overall

Indexed [2018=100]



YoY [%]



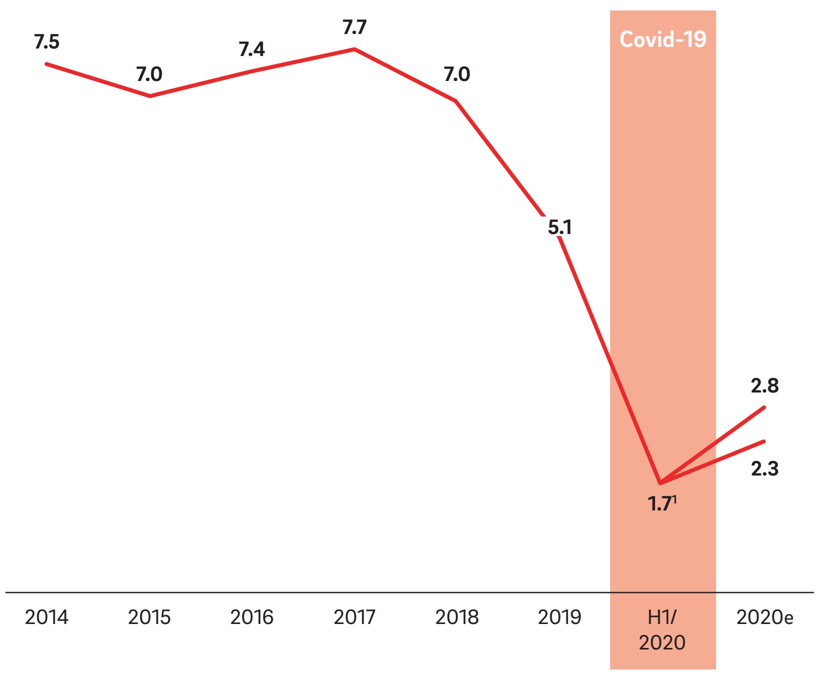
Source: Company information, Roland Berger/Lazard, Roland Berger/Lazard supplier database

Margins also declined in 2020, reaching a historic low

The pandemic caused automotive suppliers' margins to drop to a historic low. Although a recovery in the second half of the year saw an increase in earnings, these gains were not high enough to make up for the losses from the first two quarters. Nevertheless, negative full-year margins can likely be avoided by many suppliers.

From a regional perspective, Chinese suppliers not only saw lower declines in revenues but also higher margins than in North America or Europe. Despite the crisis, Chinese suppliers were able to realize an EBIT margin of 4.5% in H1/2020, after 6.9% in the full year 2019. On the other hand, margins of suppliers in North America went down significantly to an EBIT of 2.2% in H1/2020. With an average EBIT of -0.2%, European players even faced negative profitability. In an optimistic scenario, European suppliers will be able to avoid losses and reach break-even for the full year 2020.

EBIT margin [%]



Note: 2020e based on assumed full-year revenue decline of between -15% and -20%

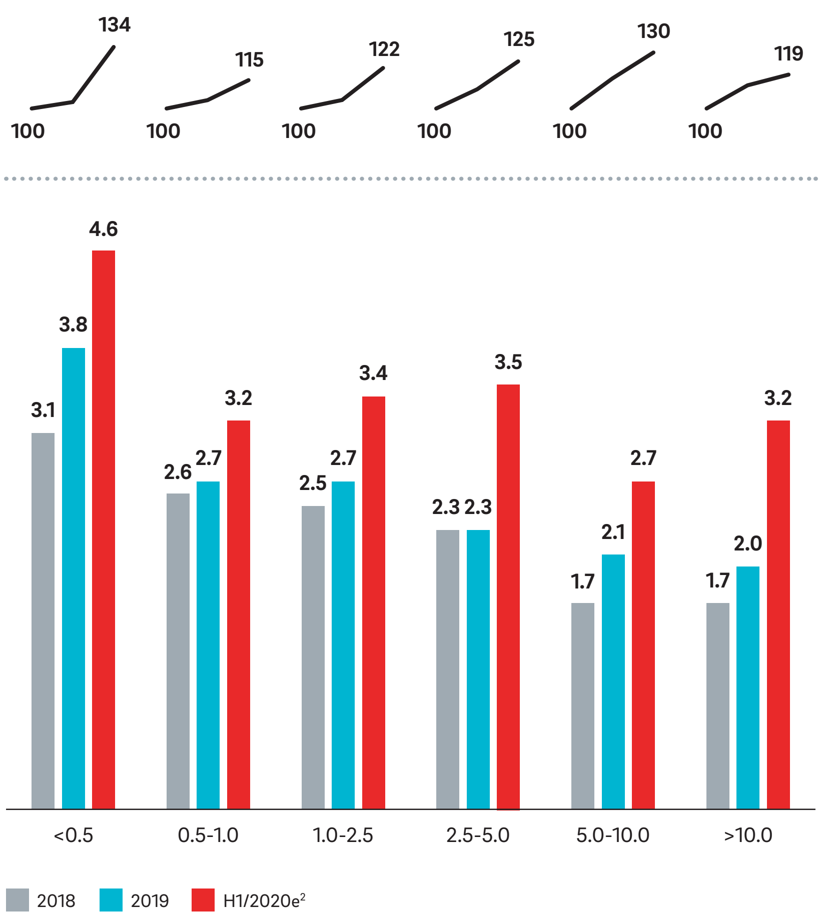
[1] H1/2020 EBIT partially manually adjusted and extrapolated for companies that don't communicate interim results

Source: Company information, Roland Berger/Lazard, Roland Berger/Lazard supplier database

Increased net debt ratios tighten suppliers' access to capital

Although an expected average EBIT margin of between 2.3% and 2.8% in 2020 looks less critical than one might have expected after the experiences in the first half of 2020, the impact of Covid-19 led to a significant increase in net debt ratios. In combination with the business slowdown since 2018, suppliers' leverages have reached critical levels of >3x EBITDA. The effect is visible across suppliers of all sizes. In consequence, access to capital is becoming more difficult for the industry. Downgrades of selected suppliers by rating agencies are reflecting this trend. Suitable countermeasures are required to secure access to finance.

Suppliers' leverage[1] by company size (EUR bn revenues) H1/2020 [%]
Actual net debt (index 100)



[1] Net debt in relation to EBITDA
[2] Based on H1/2020 net debt excluding pensions and FY 2020 EBITDA forecast

Source: Company information, Roland Berger/Lazard, Roland Berger/Lazard supplier database, FactSet

Image chinaface/iStock

The way forward – How to become a winner after the crisis

- Looking back into the last decade, the great financial crisis in 2008/09 is the only comparable situation. Dubbed a once-in-a-century crisis, it was the starting point for one of the most successful periods of growth for the global automotive supplier industry.

- We wanted to understand how successful companies handled the crisis, what strategic actions they took and how they laid the foundation for profitable growth.

- To do so, we analyzed automotive suppliers with respect to their past financial and shareholder value performance to find "best practices". Our analysis is based on financial data from suppliers across all major automotive regions from 2009 to 2019. Based on invested capital, return on invested capital (ROIC) and weighted cost of capital (WACC), we are able to distinguish four groups of suppliers: profitless growers, underperformers, cash generators and winners.

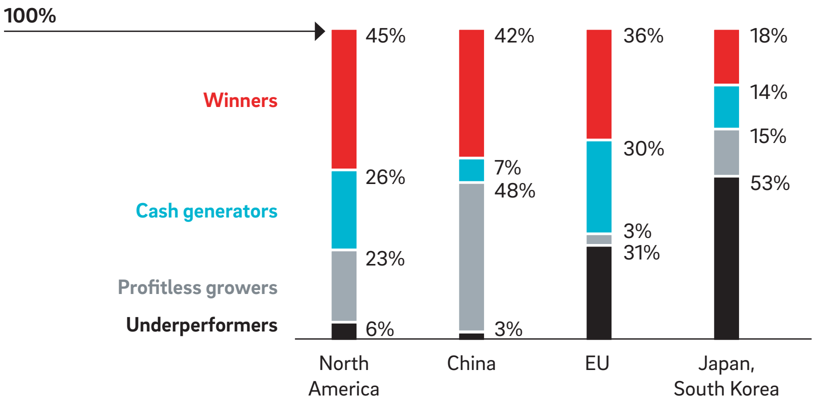
Source: Roland Berger/Lazard

Though Chinese and North American companies are overrepresented, there are winners from all regions

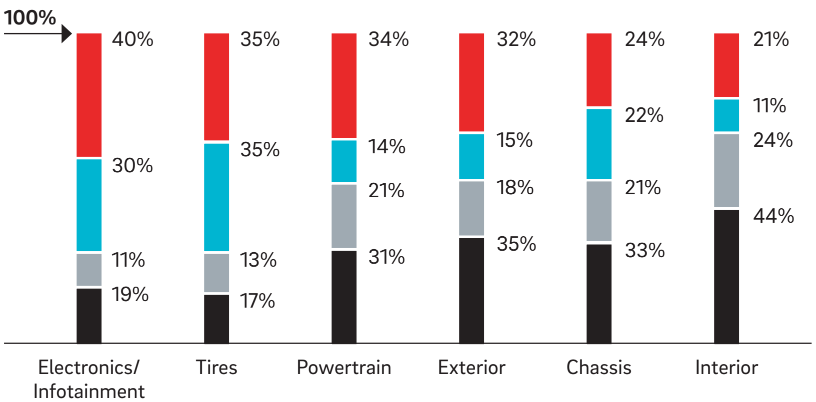
Our analysis shows that there is a clear correlation between regional allocation and financial success. Suppliers from China and North America are overrepresented among winners, while Japanese suppliers are often in the underperformer category. Nevertheless, the analysis also shows that there are winners from all regions and all product domains. Thus, there must be an underlying pattern of things that winning companies do differently than the average automotive supplier.

Financial performance per region and segment [2010–2019]

CLUSTERED BY REGION



CLUSTERED BY PRODUCT SEGMENT



Source: CapIQ, Roland Berger/Lazard

Success is determined by four strategic characteristics

As a result of our analysis, we derived four key characteristics that successful suppliers have in common and that should serve as overarching guidelines for strategic adjustments in the future.

1

BUSINESS LEADERSHIP

Can your businesses **set the agenda** in their areas of market participation?

Technology leadership

Know-how leadership

2

STRATEGIC COHERENCE

Do you have a **consistent strategic rationale** across your portfolio?

Similar requirements

Similar value proposition

3

SIZE AND FINANCIAL POSITION

Are you **relevant in the marketplace** in terms of size, financial success or technology with the ability to efficiently attract capital?

Trusted capital market partner

Convincing equity story

4

PROVEN ABILITY TO EXECUTE

Can you **deliver results** on a sustainable basis?

Short reaction times

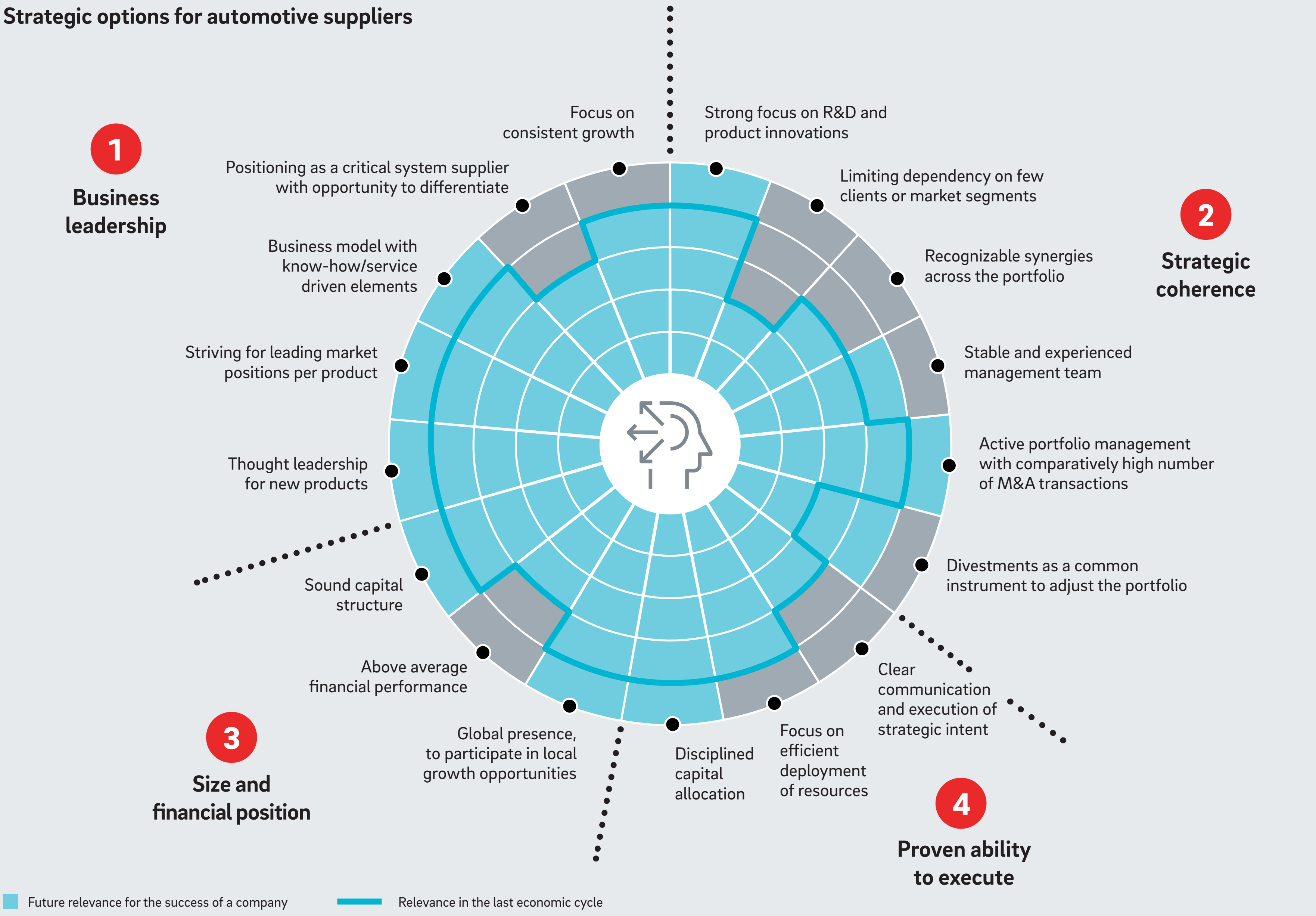
Performance driven culture

Source: CapIQ, Roland Berger/Lazard

The overarching strategic characteristics boil down to concrete and actionable success factors for automotive suppliers

Despite different company settings, certain patterns emerge of what winners do differently than the average automotive supplier. These patterns can be adapted by other suppliers to boost their performance.

Strategic options for automotive suppliers

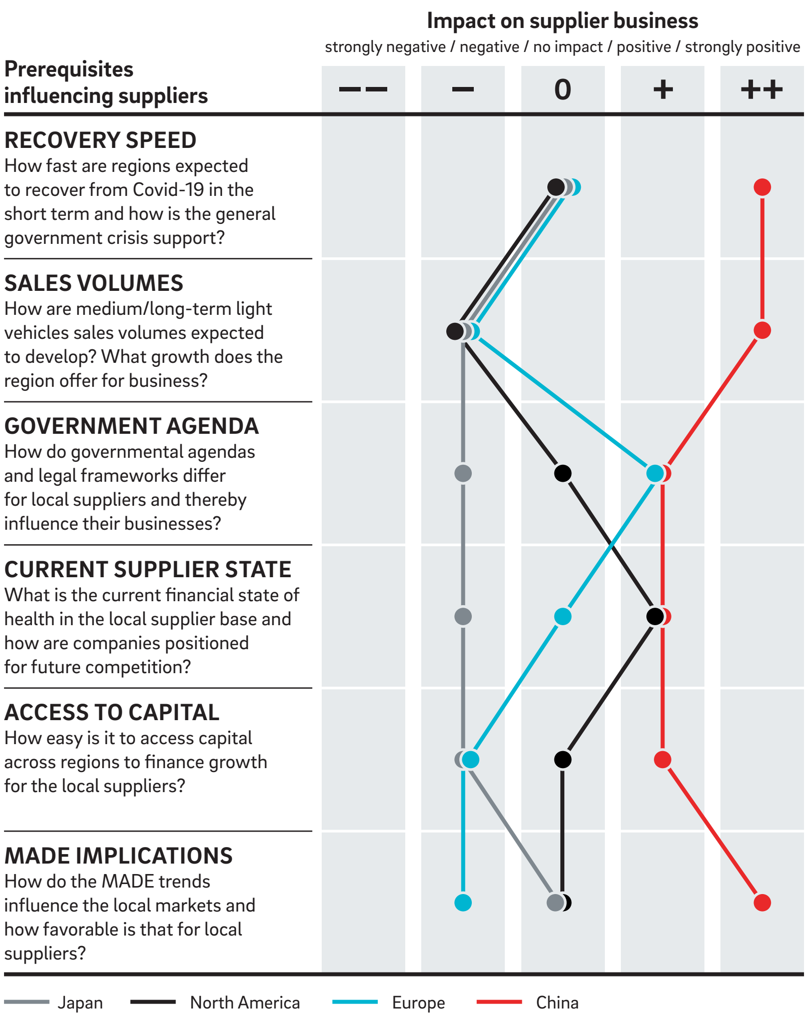


Source: Roland Berger/Lazard

Suppliers must adjust their strategies to regional market conditions

Our analysis shows that there are successful automotive suppliers across all regions. However, suppliers must analyze regional market conditions and adapt their strategic roadmap accordingly. Regions like China currently offer a better perspective due to their speed of recovery, high volumes or a push for new technologies. Suppliers from Japan, for instance, might have more difficulties finding the way out of their Keiretsu structures and implementing a growth strategy for the future.

Differentiating factors and prerequisites across regions

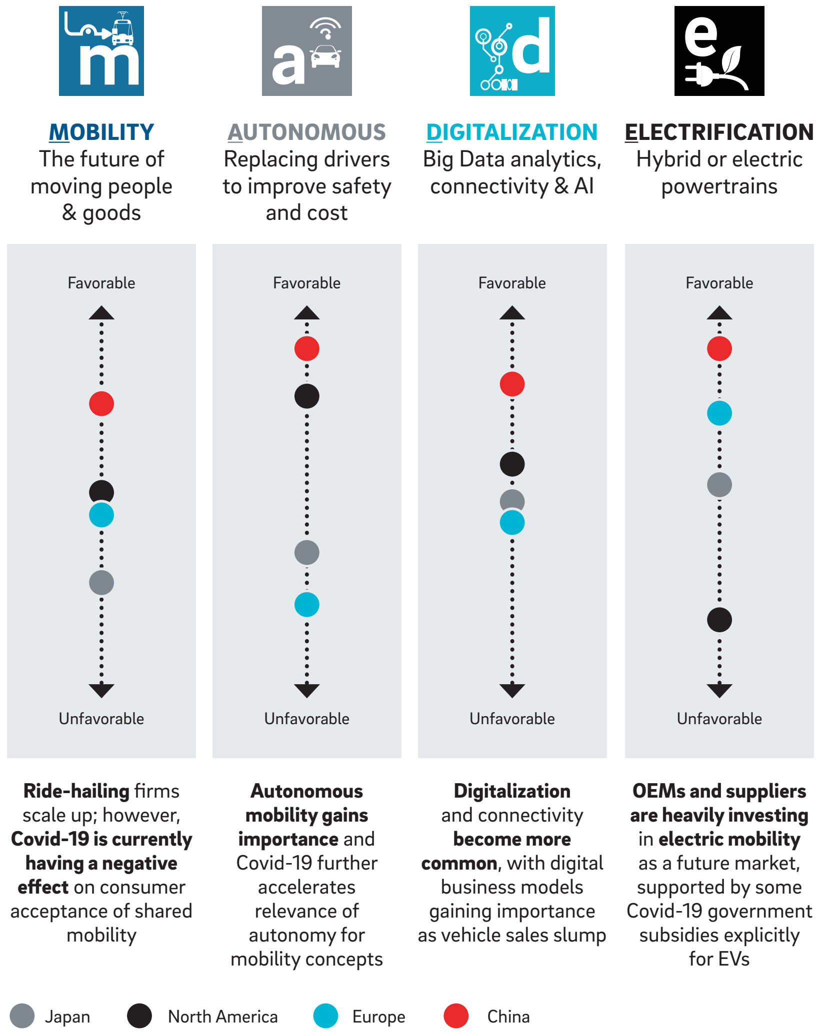


Source: Roland Berger/Lazard

Beyond the current crisis, suppliers must handle the industry's transformation

The trajectory of the transformation of the automotive and mobility ecosystem is not impacted by the current pandemic. Without a doubt, Covid-19 has reshuffled the cards regarding shared mobility and has led to a push for electrification caused by government incentives. Nevertheless, the long-term picture is still the same.

Regional impact[1] of future technologies

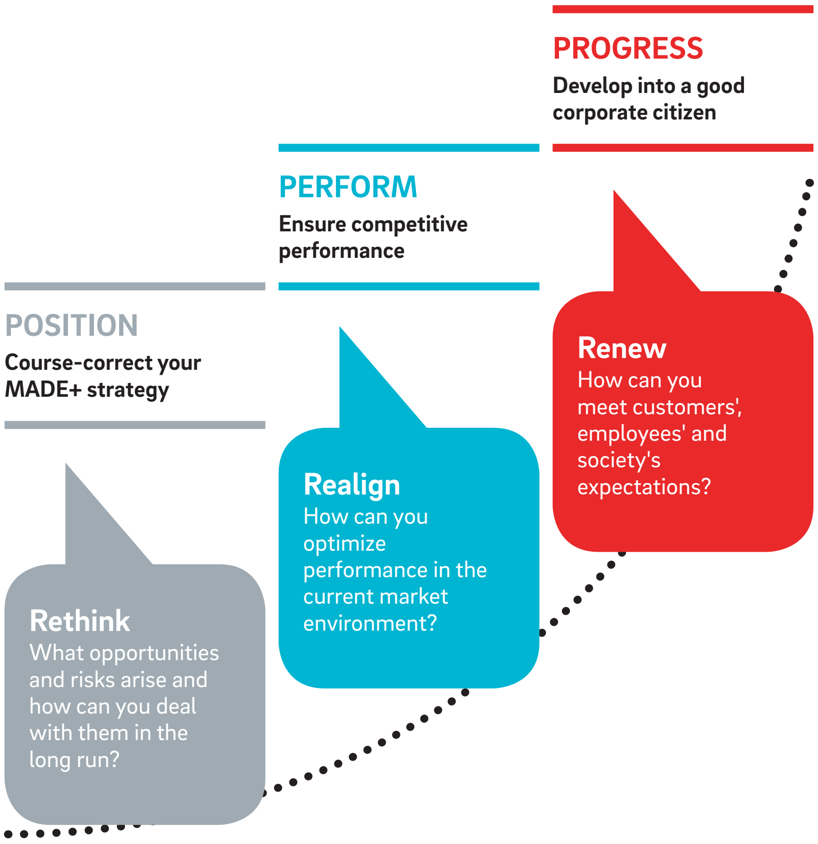


[1] Qualitative assessment

Source: Roland Berger/Lazard

To successfully navigate complex challenges we developed the Triple Transformation Framework

Triple Transformation Framework



The Triple Transformation Framework helps companies address today's challenges, enabling managers to realign and ensure profitability in the next decade

Source: Roland Berger/Lazard

Suppliers must take Covid-19 as a chance to adjust their strategies

- Along with the automotive industry's transformation, Covid-19 is the starting point for a new economic cycle
- A thought-through and consistently executed strategy is the key to success
- Classic cost-cutting programs will not be sufficient, suppliers must consider course-correcting their overall strategy
- Radical restructuring or even disposal of legacy businesses with weak competitive positioning is required
- Suppliers must consider alternative ways to fund growth opportunities – for example, minority IPOs or spin-offs
- Smart partnerships beyond joint ventures will become key for successful collaboration
- Suppliers must become more agile to successfully handle an increasingly volatile market environment

Source: Roland Berger/Lazard

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