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US automotive restructuring trends

Navigating the road ahead

The automotive industry experienced a period of growth from 2010 through 2019 as noted by North America sales volumes increasing at a compound annual average growth rate of almost 5% per year. Distress and bankruptcy within the automotive supply base were also minimal since the 2008/2009 recession. However, since 2020 there have been several headwinds all of which have impacted the industry in a relatively extraordinary manner.

The industry has faced a global pandemic (including prolonged shutdowns), supply chain shortages, labor issues, inflationary cost pressures and logistical issues. All of these have caused (and continue to cause) stress throughout the entire automotive supply chain. Additionally the recent rise in interest rates adds higher costs of refinancing and raises the broader question of consumer affordability, which could weaken demand / increase need for incentives and hence further stress the industry.

These headwinds were initially offset partially by government assistance through various programs such as the Paycheck Protection Program and Employee Retention Tax Credit recovery. These programs supported certain suppliers temporarily and delayed distress. Now that most of the government funding has ended, suppliers are facing more financial pressures and turning to other stakeholders for liquidity.

Financial deterioration

While automotive production has been impacted by the headwinds noted above, automotive OEMs have been able to capitalize on the environment and tighter inventory levels by reducing incentives on new vehicle sales and prioritizing higher margin vehicles (Trucks, SUVs). In a sample of 10 automotive OEMs median Earnings Before Interest, Depreciation & Amortization ("EBITDA") increased from approximately 9.0% in 2019 to 13.8% in 2021 (Source: Capital IQ).

In contrast, automotive suppliers financial position has weakened since 2019. In a sample of 35 public automotive suppliers we noted a decline from a median EBITDA margin of 10.2% in 2019 to 8.7% in 2021 (of note the median EBITDA margin in 2020 was 8.4%) (Source: Capital IQ). While the public supplier benchmark group were some of the larger automotive suppliers, we have also noted increased distress in practice within smaller tier 1 and tier 2 private suppliers. This is likely due to these suppliers typically lacking the financial resources, labor talent and sophistication of their larger competitors. Thus some of the more severe financial strain might not reside with the large, public global suppliers but those further down the supply chain which can cause disruption to a customer just as easy and highlights the need for enhanced supply chain visibility.

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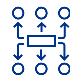
The dichotomy of profitability between OEMs and suppliers is creating tension in the relationship as suppliers are increasingly addressing volume shortfall and inflationary pressure claims with their customers. With pre-pandemic volumes in the United States not expected to be reached until 2025 (with risk even further), there are still additional years that will require financial discipline and focus to survive.

Lenders/Debt

Lenders appear to be getting more aggressive with their borrowers related to defaults and/or covenant issues. Where during the COVID-19 pandemic borrowers appeared more flexible on these issues, they are now strongly encouraging borrowers to address problems and find solutions. With several interest rate increases already taking place (and more expected), the cost of debt has increased which will further strain cash flow, liquidity, and refinancing. Especially vulnerable will be those companies that borrowed significantly in the past when debt was cheap and have experienced deterioration in profit and cash flow.

Lenders can often be a first point in distress as they have the ability to terminate funding, demand repayment of debt and other actions to protect their interest. Often times the lender will suggest the borrower hire a financial advisor to assist with finding solutions to the concerns and provide a more impartial analysis of the business.

It is also important for suppliers to understand how their current capital structure could be impacted by near to long term liquidity issues. Interest rate increases, inventory expansion, A/R collection slowdowns, and slowing demand all contribute to potential challenges related to lender covenants and leverage ratios. Suppliers can expect tightening credit markets and increased scrutiny from lenders and bond holders. Waiting to refinance in a stressed and distressed state during a recession is challenging and expensive. Building covenant testing models, communicating with transparency to lenders and ensuring sufficient liquidity are often critical to success.



Supply chain constraints

The COVID-19 pandemic caused supply chain issues due to cessation of production of critical components for the automotive industry. Semi-conductor shortages were well publicized and are still impacting production. These material shortages have caused OEMs to cancel production shifts and alter production schedules with little notice causing operational inefficiency and increased cost throughout the supply chain. It should be no surprise that semiconductors and other technology content in vehicles is anticipated to grow in the future, where the automobile is becoming more like a computer on wheels.

Beyond semiconductors, lithium-ion batteries require several raw material components including: lithium, nickel, cobalt, manganese, silicon, copper and graphite. Demand for these materials is expected to increase significantly with the ramp-up of EVs. Given much of this critical raw material production/refinement is in countries such as China, Argentina, Democratic Republic of Congo and Russia creates strategic and national security concerns for the United States and US based companies.

As such, we expect there to be continued volatility and supply/demand planning issues with key

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raw materials within the supply base as the industry shifts—and planning for these now are critical. Several OEMs and Tier 1 suppliers have announced partnerships and are working proactively to secure their own supply chain of these critical materials to avoid disruption.

Global demand for critical minerals needed to decarbonize the nation's economy is expected **to increase by 400-600% over the next several decades** and the U.S. is increasingly dependent on foreign sources, some adversarial, for many of the processed versions of these minerals. Notably, there are challenges associated with mining, processing and production of critical elements, which are often located in a handful of geopolitically sensitive regions."

—DOE Announces $39 Million for Technology to Grow the Domestic Critical Minerals Supply Chain and Strengthen National Security (10/27/2022)

Labor

Hiring and retaining qualified employees has been a continual challenge for the auto industry over the past several years. After the COVID-19 pandemic some employees decided not to return to the workforce. In addition, given labor scarcity on an overall basis many companies have had to increase hourly wages to remain competitive in being able to attract and retain employees. Some companies turned to excessive use of contract employees or temporary labor sources which generally are not as efficient and more expensive than direct employees. The volatile and last-minute changes of OEM release schedules also make it difficult to manage the direct workforce. And in a constrained labor market, suppliers feel the need to pay the work force even if they are not producing, to maintain a workforce for those days/weeks when production volume requirements are closer to contractual rates. Thus you have a situation where direct labor expense acts more like a fixed cost. These labor issues have led to a higher risk of inefficiency, poor quality and excessive costs in the operations.

Companies are getting creative on using data and analytics to target more effective recruiting efforts. There have also been collaborations between business and local community colleges or trade schools in an attempt to encourage more students into the automotive profession while offering internships with the hope to secure future employees. While there has been focus on attracting talent, just as important is having a robust culture/process for retaining existing talent. Continuing to be innovative and focusing on the labor force with as much rigor as quality and delivery can lead to a long-term competitive advantage.

Inflationary recovery

The increasing inflationary environment in the US has caused many inputs to increase which have put further strain on margins. Auto suppliers continue to face headwinds such as higher labor and freight costs, energy inflation and other non-commodity supply chain cost increases.

The cost of commodities used to manufacture a car has roughly doubled since the start of the pandemic. Automakers are generally required to compensate suppliers for higher commodity costs. Automakers are also increasingly being asked by suppliers to compensate them for higher non-commodity supply chain, such as ocean shipping, diesel, freight, logistics, electricity, natural gas, or even labor costs. Increased cost sharing on the part of automakers of non-commodity supply chain costs could pressure automaker margin."

—JP Morgan, Aug 2022

It has been publicized that suppliers are having difficult discussions with their customers on relief for these increasing costs. While it appears there are a variety of approaches being taken in these discussions, we believe a transparent, consistent, logical, data-based approach is a good starting point on both sides of the table. Given the current dynamics of supply shortages where every sale is critical, having a strong and

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efficient supplier network is critical to success. There are also fewer supplier options now than there were in 2008/2009; thus creating fewer options for the OEMs. As such, we believe there will need to be collaboration with the supplier-customer relationship.

Within this current environment where suppliers are asking customers for inflationary relief it can be difficult to distinguish if the request is solely a commercial issue or a sign of something more structural/deeper. From a customer perspective these requests are an opportunity for a more holistic review of the supplier to assess both current and future risk. Having a defined process for addressing price increase requests should be considered.

> The situation is not nearly as dire as the Great Recession of 2007-09, but suppliers across the tiers continue bearing the brunt of supply chain pain, and they are not afraid of pulling the bankruptcy card"
>
> —**Crain's Detroit—Auto suppliers' latest tool in renegotiating contracts: bankruptcy**—October 12, 2022

While it is easy for a supplier to raise the bankruptcy option if a commercial issue is not resolved, the customer should not automatically fear this path. There are many instances when a bankruptcy option could be the best long-term path forward. This does however involve a thorough analysis of the cost, risk and other options that are available and should be with a cross-functional team.

Mega-trends

There are several mega-trends shaping the industry including: ICE to EV transition, alternate powertrains, autonomous vehicles, connected driving and sustainability/ESG—all of which creates future risk. OEMs and suppliers are determining their future strategic path and the actions that must be accomplished to achieve long-term viability. We are expecting that there are current industry participants that will not have a place in this future.

There have already been several M&A transactions spinning off ICE related businesses, companies separating out ICE and BEV divisions, and private equity and other type firms looking to potentially roll up ICE businesses.

Suppliers must be thinking about future volumes, plant footprint, capacity requirements, capital requirements and how each of these dynamics should be addressed based on their strategic business plan. These are not easy questions to address and highlights the importance of taking proactive measures to determine an optimal path forward before it is too late and that path is determined for you.

Cash forecasting

An effective cash flow forecasting system is essential and should be utilized to manage and plan within the organization. This is true not only in good economic times, but becomes even more critical when facing distress or a recession. The forecast comprises the collections and the disbursements for maintaining operations, as well as the capital requirements and debt service requirements. This forecast includes managing working capital of the operation to reasonable levels that allow the operation to run effectively and efficiently and minimize the cash tied up in inventory and receivables. Having both good systems in place for a short-term (13-week cash flow) and longer-term business plan (3 statement model) is considered a leading practice.

As an example, we recently completed an engagement that involved building a complex short-term and long-term cash flow and total liquidity forecast for a Company and its Private Equity sponsor allowing them to gain

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further insight in cash requirements (e.g., debt service, vendor payables, etc.) over 18 months to determine the range for a potential capital injection.

The Company received a global consolidated cash flow forecast, allowing them to gain visibility into its future cash flows under varying scenarios which enabled the Private Equity sponsor to inject an appropriate amount of liquidity to fund the business through the supply chain struggles and near-term acquisitions, allowing stable operations moving forward.

While it is certainly challenging to forecast in the current, disruptive environment there is the ability to build dynamic scenario planning. Mapping a range of scenarios and assumptions and applying these to a financial plan will yield a range of outputs. The goal would be to have defined action plans for each scenario that can be rapidly executed when/if needed. Having cross-functional and top leadership support and participation in this process is critical to its success.

Conclusion

The US automotive industry has faced a myriad of head winds over the last 3 years and new challenges continue to emerge providing continuous shocks to the ecosystem. While there were learnings and resiliency from the 2008/2009 financial crisis that have been applied, there is concern with the weakened state of the supply base and future trends that M&A and restructuring activity will continue to increase as the winners and losers are sorted out.

Being proactive in understanding the strategic landscape, focusing on the labor force, preparing scenario planning, enhancing cash management, and having sound operational processes are some areas to focus on while journeying down this tumultuous path.

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