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by Kasturi Rangan and Evan Hirsh

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Reprint

Auto Suppliers in Crisis:
1. The Coming Shakeout

This bedrock U.S. manufacturing sector is facing consolidation, further cutbacks, and renewal.

by Kasturi Rangan and Evan Hirsh

Although auto suppliers comprise the largest single manufacturing sector in the United States, with about 400,000 workers as of July 2009 — more than three times as many employees as automobile manufacturers themselves — this sector is also one of the country's most troubled. Indeed, that employment figure reflects a drop of 140,000 jobs in 12 months. And those job losses, unfortunately, are among the first in a radical restructuring that will rapidly change the face of the North American auto industry.

The retrenchment of the Detroit Three has pushed North American suppliers to the brink of bankruptcy. Veteran companies like Visteon, Delphi, and Lear are already in Chapter 11, and the balance sheets of TRW Automotive and Tenneco are burdened with unsustainable amounts of debt. Several smaller suppliers have filed for protection from creditors or have completely exited the business. This sectoral correction has been a long time coming; it will likely result in an industry populated only by successful, more targeted suppliers. Those that were in crisis for the last decade or so will be gone. The restructuring will be marked by the elimination of nonproductive assets and capacity, a shift in suppliers' portfolio of products from broad to focused, and an inflow of private capital that will lead the transformation.

If American auto suppliers could relive the last quarter century, they would probably do things very differently. They tied their fortunes unconditionally to General Motors, Ford, and Chrysler and are paying dearly for that decision. But then, it wasn't so much a decision as an evolution. As recently as the late 1980s, the Detroit Three still had an enviable 70 percent market share in North America. Yet even at that time, their overhead and legacy labor costs (particularly pensions) were clearly a burden, making it difficult for them to compete against newly aggressive Japanese and Korean competitors. To remain profitable while meeting these real and projected outlays, the U.S. automakers cut corners, sacrificing quality and design. By the start of the 21st century, their market share had begun to erode significantly; it tumbled below 50 percent in 2007.

Unable to reduce capacity, the Detroit Three swung for the fences and introduced many new models, hoping for the hit that could make up for their increasing number of unprofitable brands and styles. By 2004, they were making upward of 130 models, compared to only about 30 manufactured by Toyota and Honda together. In North America, there were 30 percent more models than the market could profitably accommodate — and most of these belonged to the Detroit Three. The automakers tried deep discounting, price wars, and rebates in a desperate effort to hold their own. None of these strategies worked, and the structural weaknesses continued to build until the onset of the global recession and credit crisis, which precipitated a 40 percent crash in sales of annual North American car and light truck units, to roughly 10 million.

Auto suppliers essentially went along for the ride, without considering the risky path charted by the Detroit Three. Companies such as Visteon, American Axle, Tenneco, and Delphi, inexorably linked to Detroit, had bet their future on high volume from the new platforms and models that were being introduced. The sales never materialized, capacity swelled, and structural problems worsened. For well over a decade, North American suppliers generated returns on investment of a mere 4 to 6 percent, not nearly enough to cover their cost of capital.

Other problems plagued the North American supplier industry as well. In some cases, new suppliers with factories in low-cost nations — predominantly China, India, and Mexico — emerged to gradually reduce the cost competitiveness of existing plants in the U.S. and Canada, and even to wrangle contracts with American automakers. Under some financial strain, U.S. suppliers didn't have the wherewithal to shift capacity to these less-expensive locations fast enough. And selling new business to the rising number of transplant automakers in the U.S. — primarily Honda, Toyota, Nissan, and Hyundai — was not a real option. Most of these nondomestic automakers had existing relationships, often joint ventures, with suppliers in their home markets, and brought these companies with them to the United States. That, in turn, added further capacity to the already overextended North American supplier industry.

As the auto suppliers fight through the turmoil of the next few years, the biggest change in the industry will be the transformation of large, unwieldy suppliers with multiple product lines into streamlined companies that make parts for only those markets in which they have strong competitive and manufacturing positions. Decisions about which product lines to support will be based mainly on development costs: the skills required to design and engineer an item; production economics, such as manufacturing scale, the location of factories, labor costs, and logistics and distribution complexities; and market relationships.

One relatively easy way to untangle the coming consolidation and restructuring in the North American supplier market is to break down the industry's products into two categories: commoditized and technology driven.

Product development costs for commoditized items, such as brakes and batteries, are extremely low, so the market structure is driven primarily by the least expensive freight costs for equipment made by the least expensive labor coupled with manufacturing scale. For products that can be shipped inexpensively (relatively lightweight supplies such as brake calipers and pads, for example), freight costs are minimal compared to production, so suppliers will more likely be global operations making these items in low-cost countries. When freight costs are somewhat higher but not extravagantly so (for example, for batteries), suppliers will attempt to set up regional plants, close enough to the automakers to minimize shipping expenses but far enough away to enjoy beneficial labor rates and production efficiencies. And when freight costs far outweigh the price of production (as with stamped products like body panels and roofs), suppliers will, in effect, colocate with their customers.

For technology-driven products, development costs must be balanced against production economics. In automotive electronics, for example, R&D and design expertise and costs far outstrip manufacturing and logistics in both importance and price. Consequently, there will be a limited number of surviving suppliers (Bosch, Conti, and Denso are the current leaders) with factories that are essentially engineering shops providing products for global markets. By contrast, when the benefits of scaled production and high-volume output can offset high development costs (as in air-conditioning compressors), regionally concentrated markets will dominate. And when production must be local and initial investments are high (for example, in car seats), a concentrated two- to four-player structure will be the likely result. These suppliers will have to mix global reach for some products and regional reach for others to gain enough worldwide bargaining power to cover the investment costs of the locally produced items.

Simply put, North American suppliers should gird themselves for the wholesale consolidation of good assets and the purging of bad assets within each product line. In many cases, private capital may be the best source to fund such a complex restructuring, in large part because a public enterprise, with its fragmented ownership structure, is unlikely to easily swallow the execution risk, successfully manage the dozens of acquisitions and asset sales, and have enough patience for the long-term process — perhaps as long as five years — that the restructuring of the industry will require.

In North America, there were 30 percent more car models than the market could accommodate — and suppliers went along for the ride.

By contrast, private capital is much more drawn to the undervalued assets that the suppliers are holding, and private capital firms have the funding ability to liquidate noncompetitive business units and factories, write down liabilities, delink good product lines from bad, and consolidate suppliers and their core talents. In addition, private capital firms have the means to provide management with incentives to create long-term value. As overcapacity and excess players are cleaned out of crowded sectors of the supplier market, and as more sensibly organized niches with sustainable profit potential are created, the payoff may be sizable. When the restructuring is complete, slimmed-down, better-targeted suppliers could be candidates for very successful public offerings.

It has been a difficult period for North American suppliers, many of whom felt the rug being pulled out from under them as the Detroit Three rapidly shrank. But out of these deep troubles may come something that could not have been easily anticipated just a few years ago: a restructured industry whose prospects for the future could be markedly improved and positive.

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