

Riding the Storm Out: The Need For A Collaborative Model

By: Kim Korth

IRN, Inc.

550 Three Mile Road, N.W.

Suite A

Grand Rapids, MI 49544

616.785.5175 phone

616.785.5163 fax

www.irn-auto.com

August 5, 2004

A Sample of the Prevailing Attitude:

- **Significant overcapacity in the automotive industry**
- **Many of the key problems in the automotive industry appear to be fundamental, not cyclical**
- **A twenty year history of relentless downward price pressure**
- **The China threat**
- **Continued strong vehicle production levels combined with a steady decline in overall supplier profitability**

- **From an industry perspective, much of the conventional wisdom is correct**
- **Most suppliers do struggle to remain profitable**
- **The outlook for certain sectors is grim (e.g. straight stampings, simple plastics)**

Generalizations about the industry miss one important point. The scale of this industry is so vast that there can still be large numbers of highly successful suppliers when the overall industry is struggling.

**Office Furniture
Industry**

\$25 Billion Worldwide

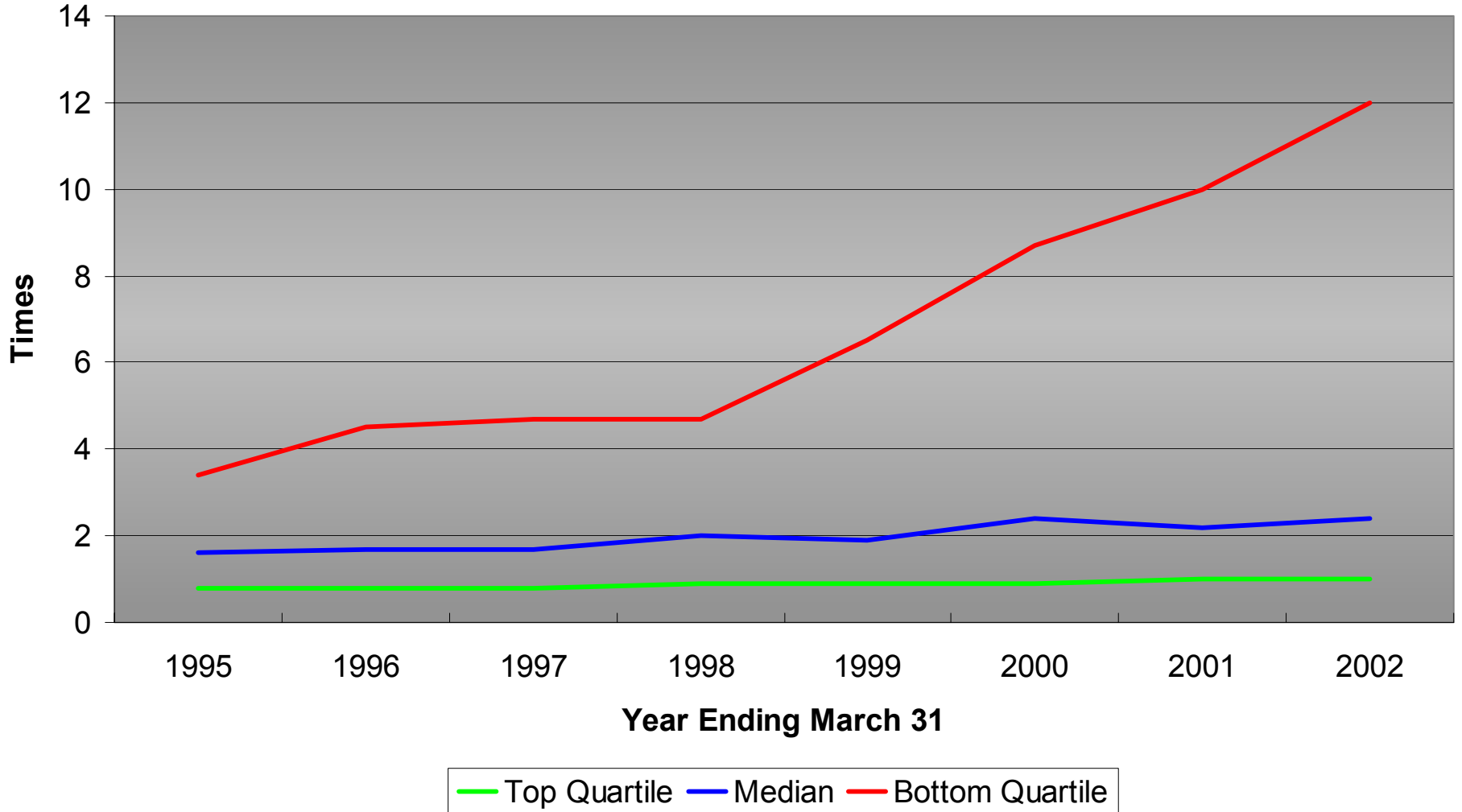
**Automotive Supplier
Industry**

\$950 Billion Worldwide

How to be in the top performing quartile of this industry.

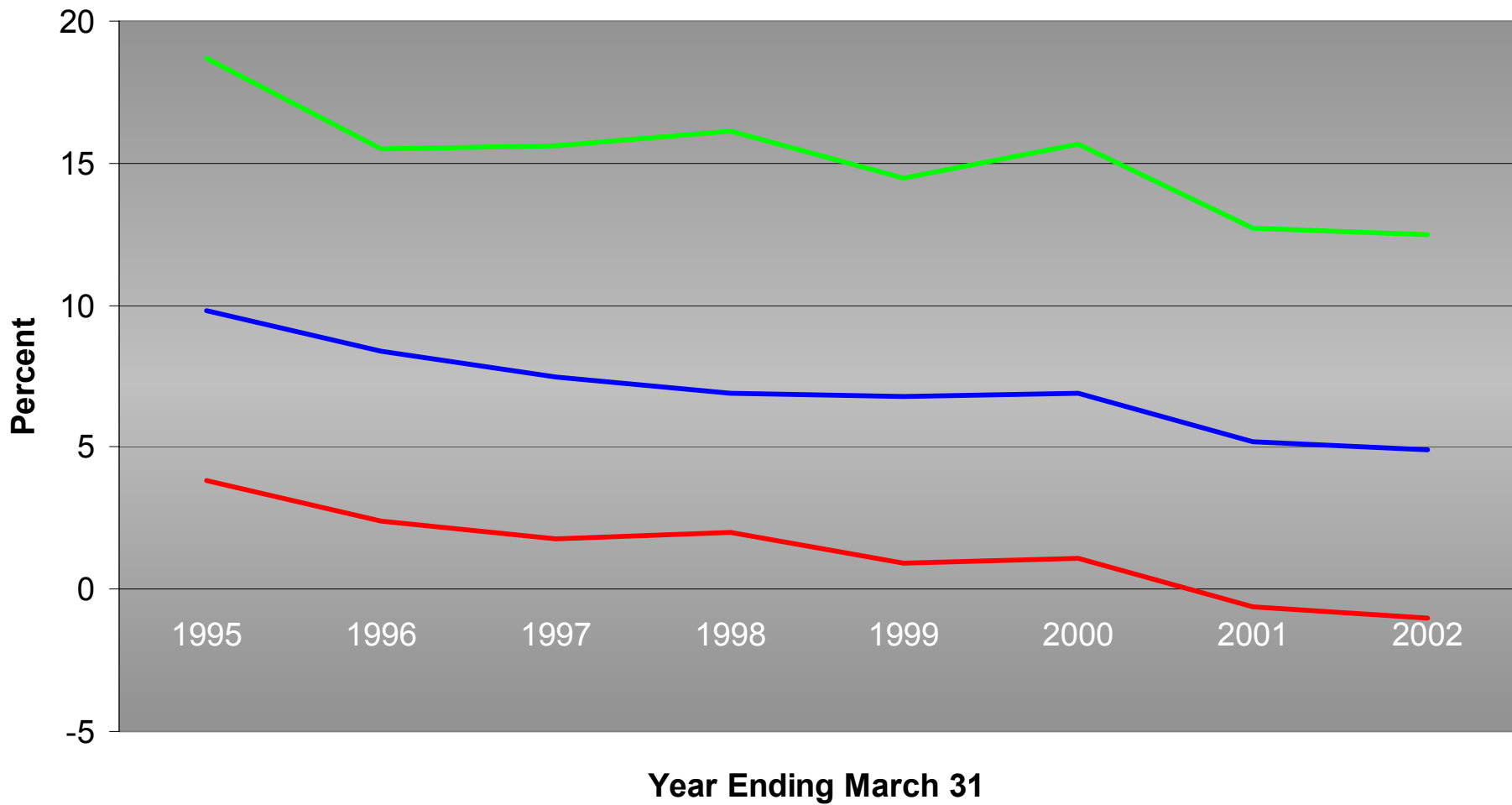
Rule of thumb: 25% of the suppliers make 60-70% of the profits

SIC 3714 Debt-To-Equity



Source: RMA Statement Studies

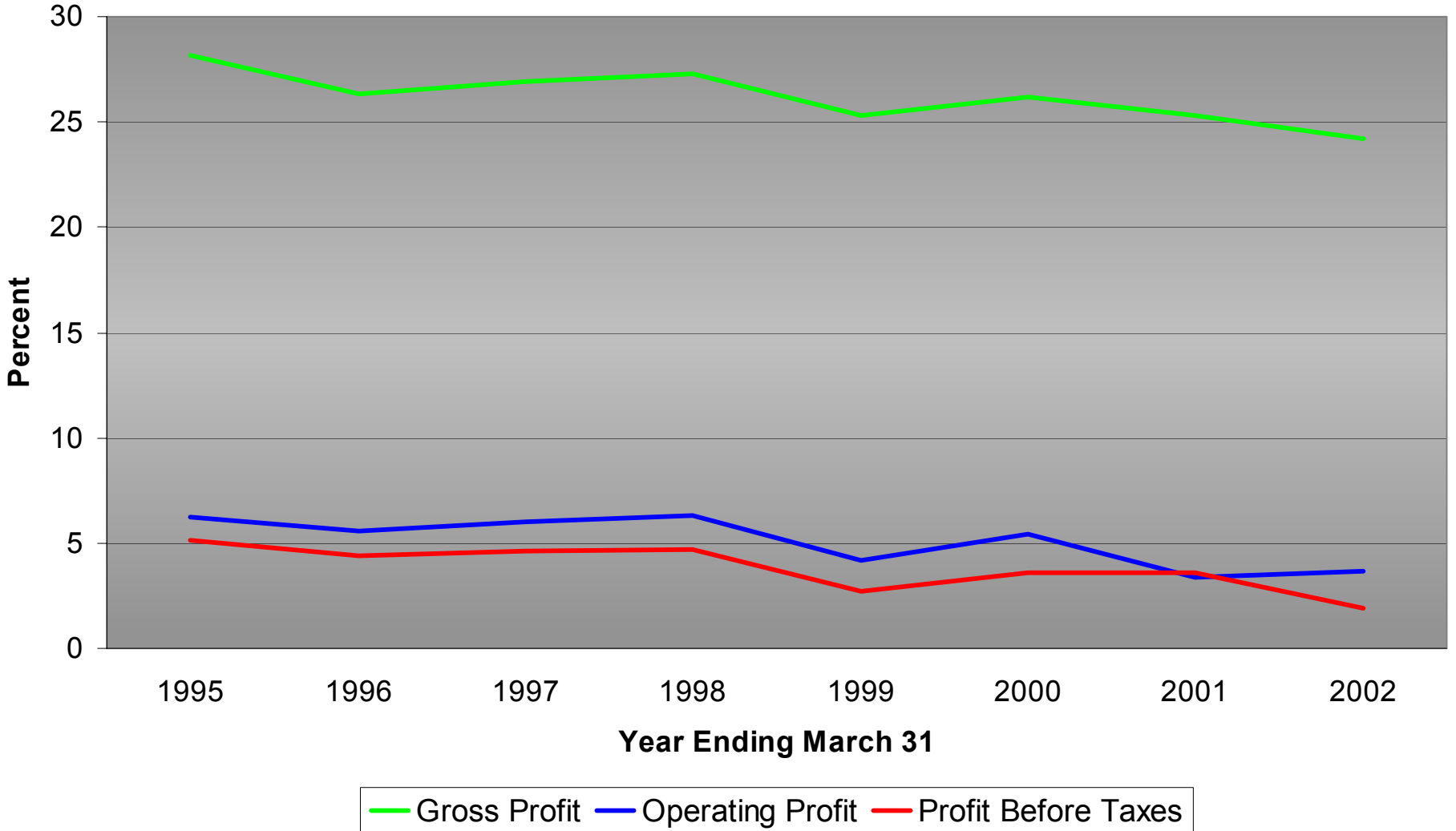
SIC 3714 Pre-Tax ROA



— Top Quartile
 — Median
 — Bottom Quartile

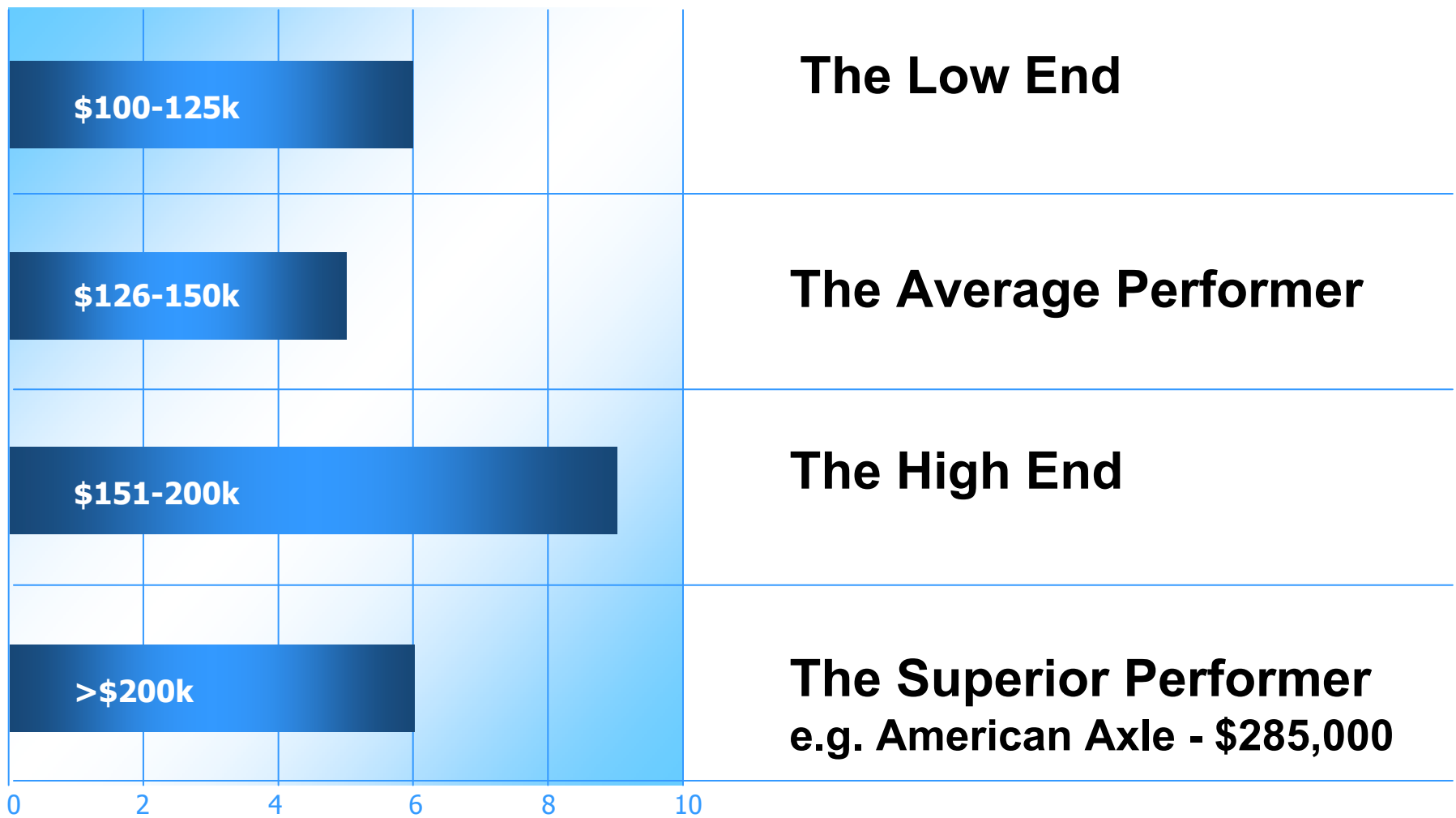
Source: RMA Statement Studies

SIC 3714 Profit



Source: RMA Statement Studies

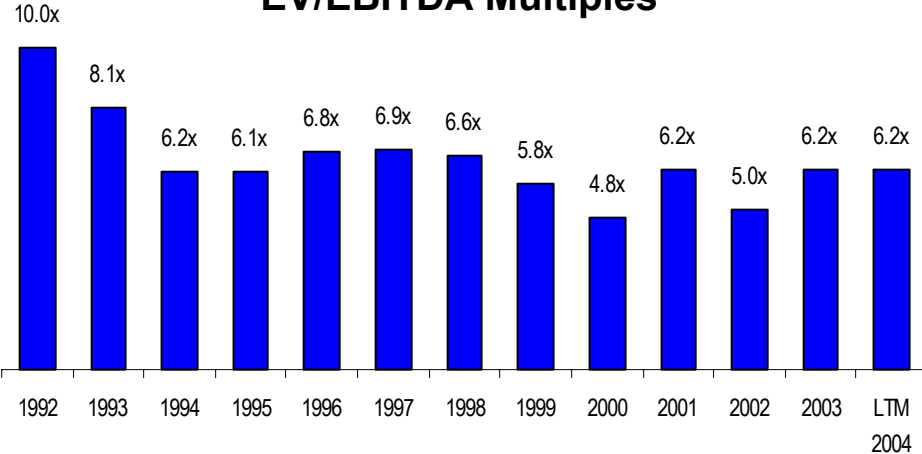
Sales Per Employee – One Comparison



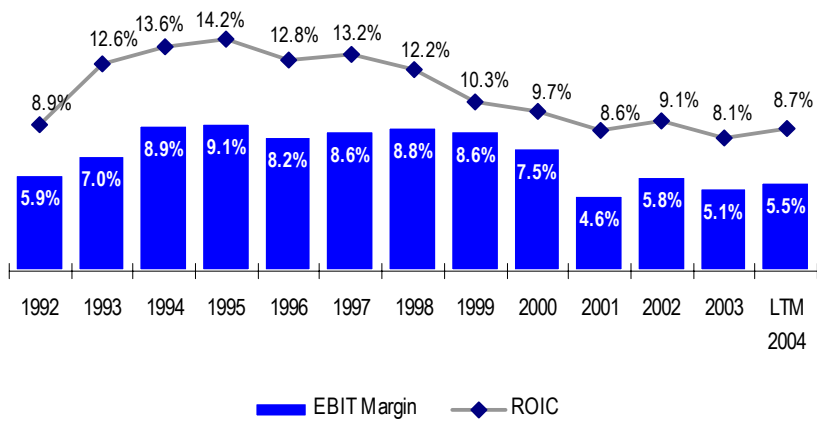
2003 data

Supplier Valuation/Financial Metrics

EV/EBITDA Multiples



Supplier Performance



Market volatility

- Market valuations are approaching highs last seen in mid to late 1990s
- Valuations declined in early 2003 as a result of a cautious outlook for the automotive industry and concerns over the geopolitical situation

Operating Performance

- Increasing operating margins coupled with decreasing debt levels of suppliers have resulted in increased returns for suppliers in 2004
- Supplier profits continue to be squeezed by OEM demands for price concessions, added design and engineering responsibility, and increased tooling cost burden
- Performance of individual suppliers varies widely depending on customers, platforms and sector



Source: FACTSET Research Systems, Inc.; 2004
 Market data as of July 1, 2004, while operating data based on most recently reported period March 31, 2004; NM = Not meaningful

What are the Drivers to Varied Performance?

- **Producing parts that are low in the supplier food chain**
- **High capital intensity**
- **Unsustainable cost structure**
- **Bad management**
- **Poor customer mix**

It is less an issue of overcapacity than it is an issue of ease of substitution:

If there are multiple substitutes for what a supplier provides their customer, they have little or no leverage.

How Much are Customers Asking For?

Amount suppliers reported being requested in the 1997, 1999, 2001 and 2003 surveys:

	Average Annual Requested			
	1997	1999	2001	2003
DaimlerChrysler	4.3%	4.2%	5.3%	7.5%
Ford	4.2%	5.8%	4.8%	7.6%
GM	3.7%	4.9%	5.9%	5.6%
Transplants	2.8%	4.1%	5.1%	5.4%
Tier Ones	4.0%	5.2%	6.1%	5.4%
Overall	3.8%	4.8%	5.4%	6.3%

- For most survey respondents, the customers continue to ask for ever-higher reductions in component price. The overall average in the 2003 survey was 6.3%, compared to 5.4% in 2001, 4.8% in 1999, and 3.8% in the 1997 survey.

How Much are Suppliers Giving?

Amount suppliers reported giving in the 1997, 1999, 2001 and 2003 surveys:

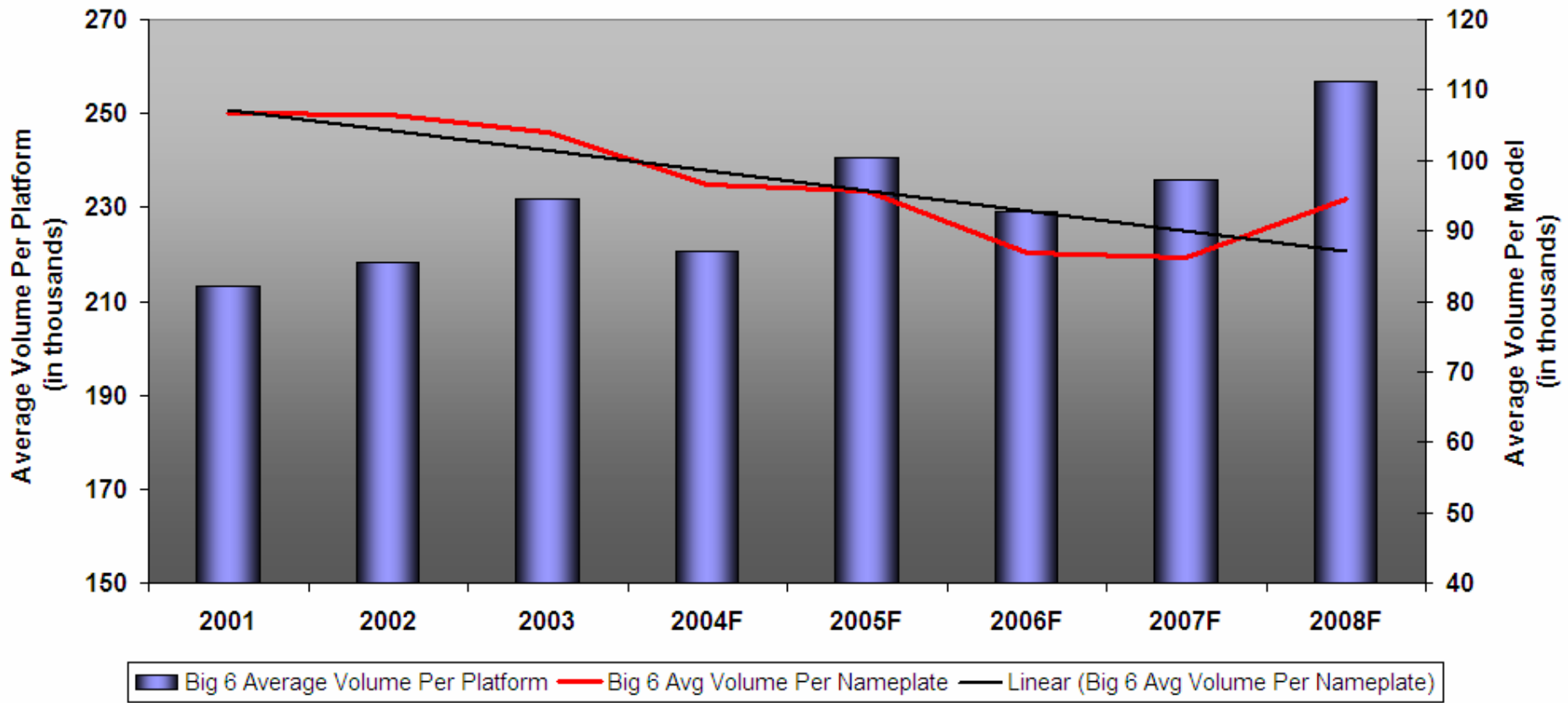
	Average Annual Given			
	1997	1999	2001	2003
DaimlerChrysler	1.4%	3.7%	3.1%	4.4%
Ford	2.4%	3.1%	1.8%	3.6%
GM	2.2%	4.1%	4.3%	4.0%
Transplants	1.5%	3.1%	3.0%	3.1%
Tier Ones	2.3%	3.9%	3.0%	2.9%
Overall	2.1%	3.6%	3.0%	3.6%

- The overall average suppliers are giving has grown from 3.0% in 2001 to 3.6% in 2003. While the Transplant and Tier One respondents are giving nearly the same, DaimlerChrysler suppliers are giving 1.3 percentage points more than in 2001 and Ford suppliers are giving 1.8 percentage points more.

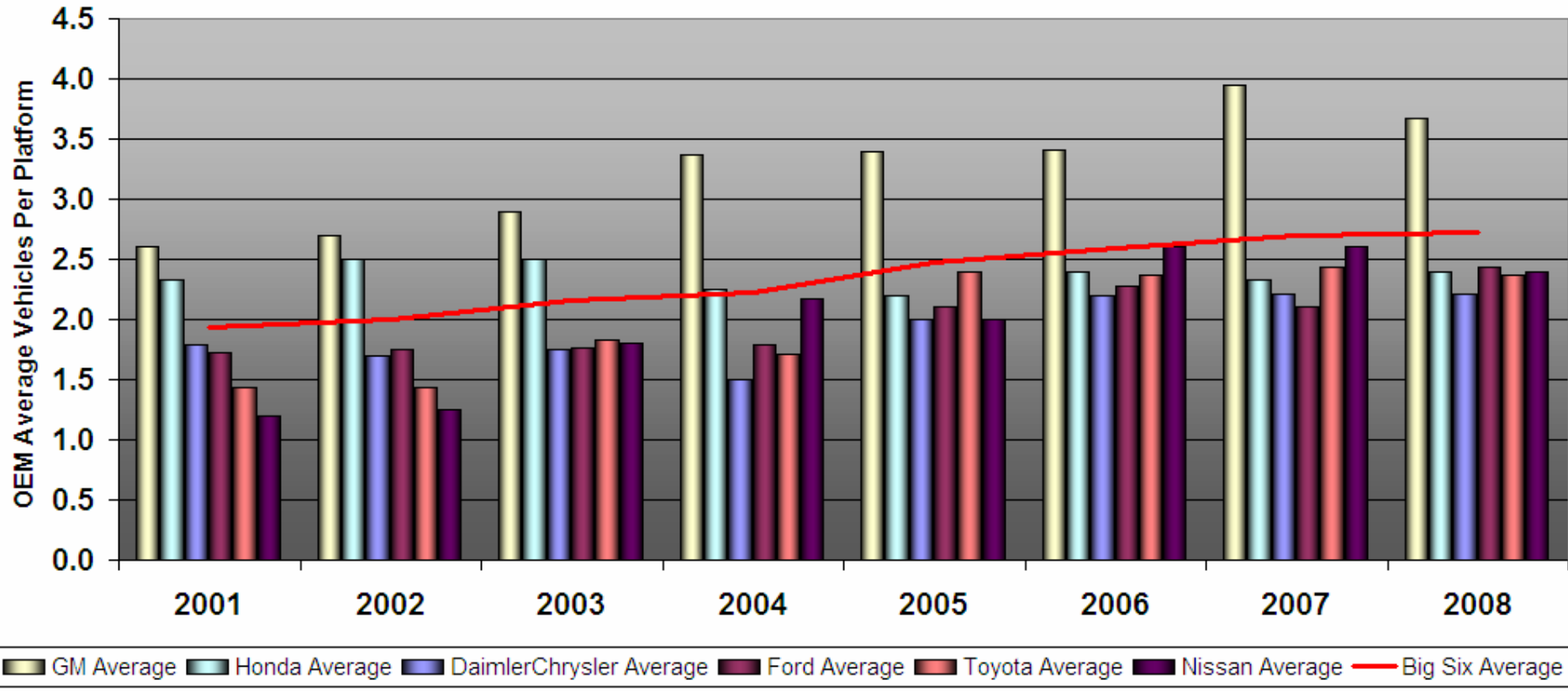
The level of capital required for many suppliers is the most consistent concern voiced by the financial community.

The level of capital investment required is both an issue of the type of parts being produced and the scale and longevity of the program.

North America Big Six Production (Average Volume per Platform vs Average Volume per Model)



North America Big Six Average Number of Vehicles Per Platform



Many suppliers have not significantly progressed in creating a more sophisticated view of their cost structure:

- Much of the emphasis is on shop floor related costs
- Many traditional accounting practices hide waste and reward the wrong behavior
- The analysis is organized around departments vs. value streams

***The Result?* Most suppliers do not know how to price their products.**

One Example – Standard Costing

Standard Costing Assumptions	Lean Realities
There is one ideal cost of any product.	Cost of the product varies according to the product volume and production mix.
Overhead costs are directly related to the amount of direct labor.	Overhead is related to the costs of the value stream as a whole, not the cost of labor.
Maximum profitability comes from the maximum utilization of production resources.	Maximum profitability comes from maximum flow through the value stream, based on the pull of the customer.
All excess capacity is bad.	Capacity should be used when it is needed to balance production flow.
High levels of customer service are provided by high levels of inventory.	Short cycle times allow you to meet customer needs with low inventory.
Production costs are controlled by detailed tracking of actual costs.	Production costs are controlled by process control and continuous improvement.
Cost optimization is achieved by optimizing each individual part of the production process.	The lowest cost is achieved by balancing the value stream to achieve maximum throughput.
(Adapted from Maskell, 2003, P. 135)	

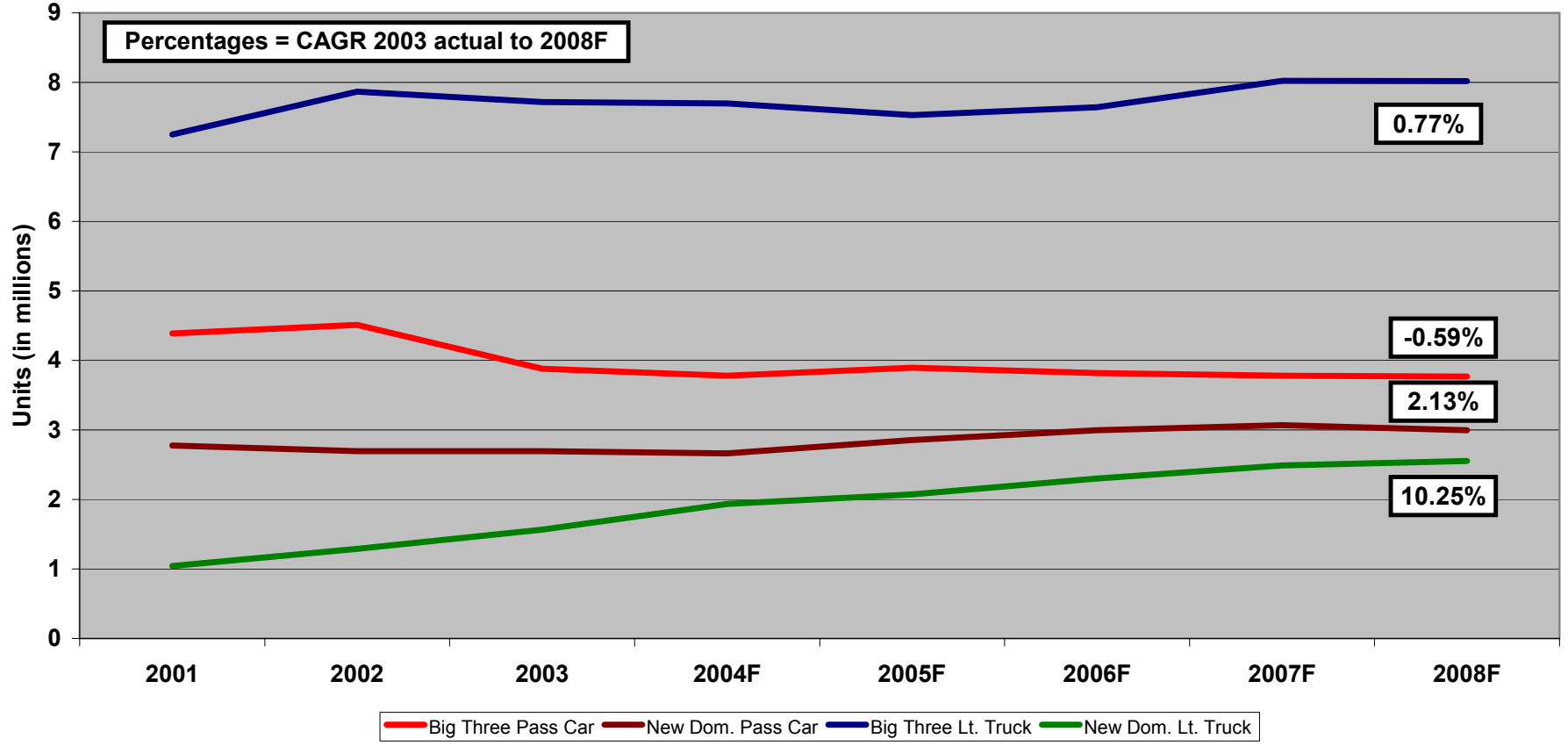
While many of the problems for suppliers are industry issues, many suppliers also have problems because they have bad and/or the wrong management:

- Failure to address key issues quickly enough
- Maintaining an old business model in a new competitive environment
- A preponderance of operational vs. strategic thinkers

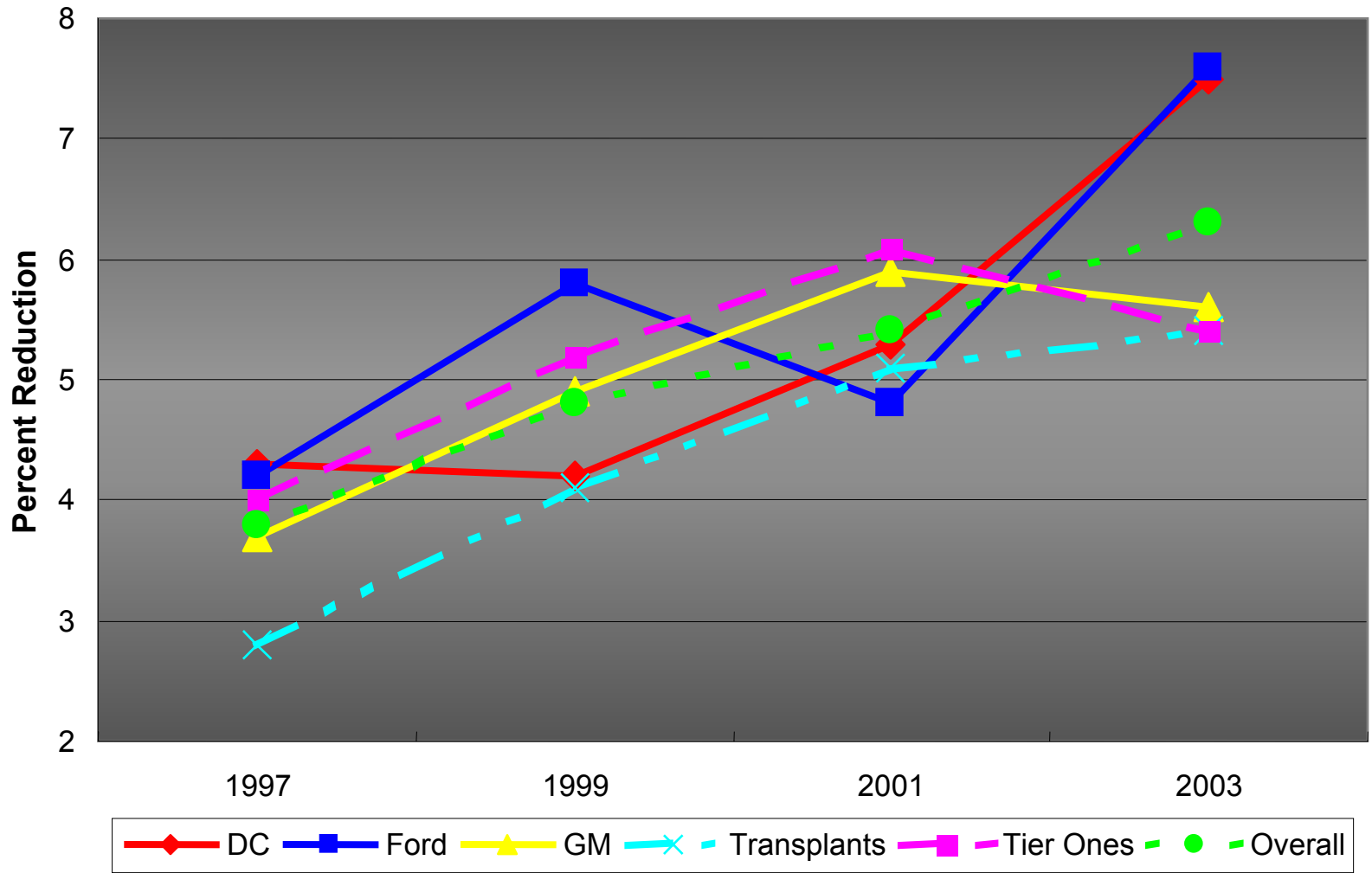
Financial Buyers: Track record of picking a resume vs. a fit.

Customer Mix is a Key Indicator of Success

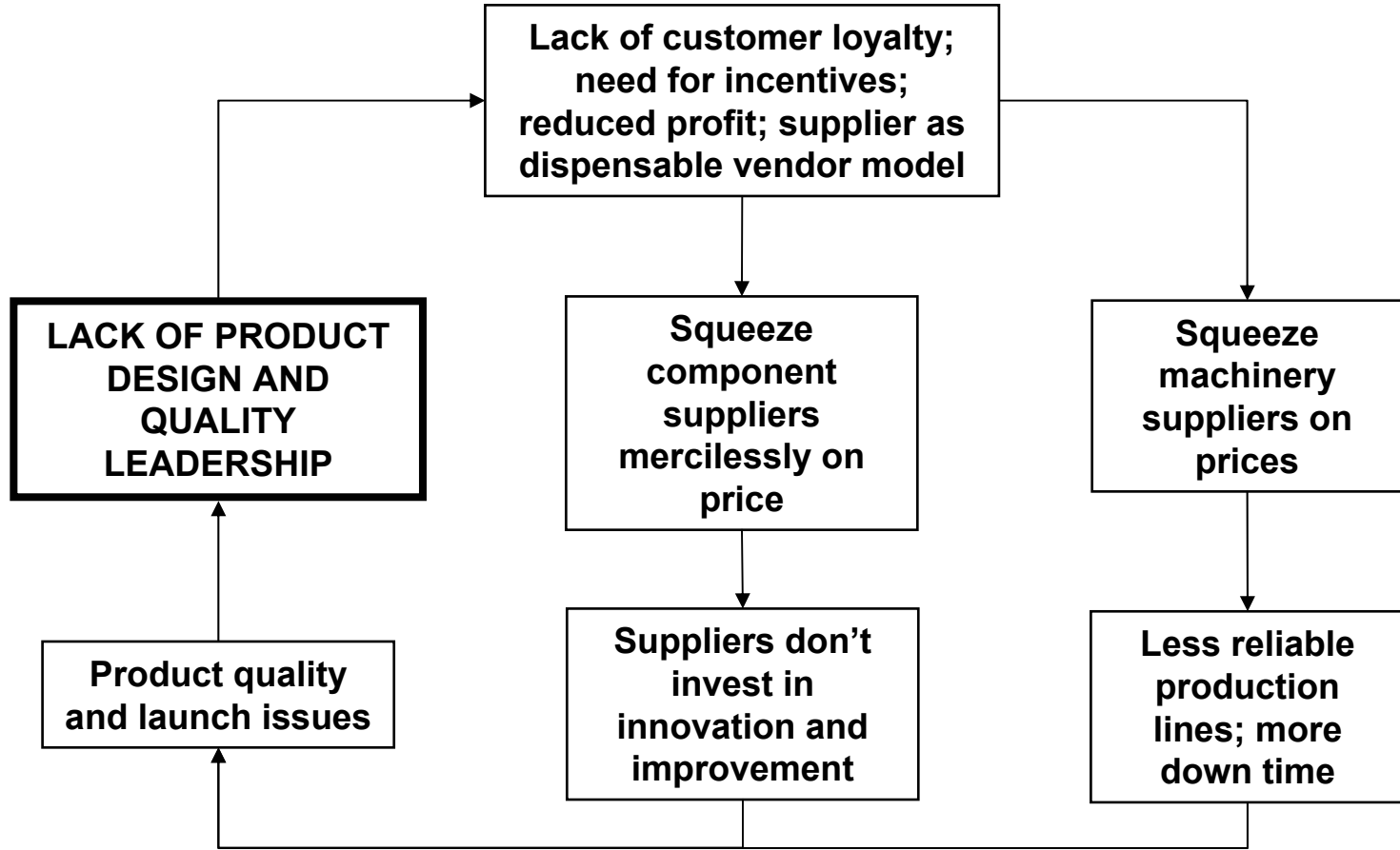
North American Light Duty Vehicle Production Forecast



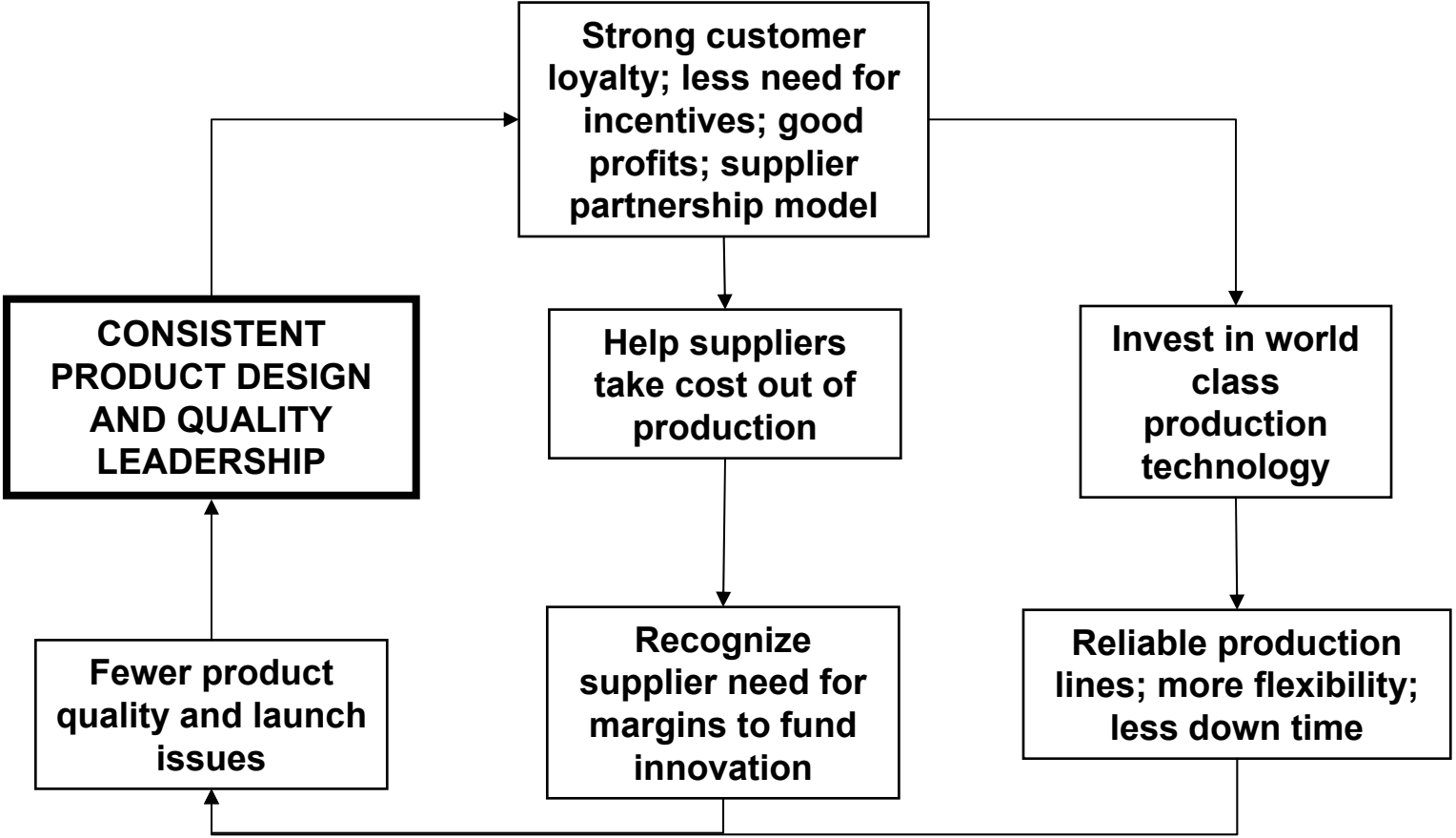
A Twenty Year History of Perpetual Cost Downs



Why the Big Three Are Struggling – The Vicious Cycle



The Future Vision – The Virtuous Cycle...



One of the least talked about issues in the automotive industry is the fact that we are at the end of the cost down business model:

- Current OEM cost reduction targets are not being met
- Material prices continue to rise (including plastic)
- Interest rates will go up over the next few years
- At least in the short term, OEM overcapacity limits vehicle price increases

The OEMs have not figured out the new model:

- 45% of the OEM middle and upper management retired between 1995 and 2003
- A whole generation of management has grown up under the cost down model with *no* other experience
- The key to success in the long term is collaboration between the sectors which requires a totally different skill set

The Problem? Supplier/OEM relationships, particularly with the Big Three, are at an historic low point.

The Philosophy the Big Three Need to Adopt

FROM:

- Adversarial approach to suppliers
- Emphasis on price vs. cost
- Focus on short term return
- Giving a supplier accountability without authority
- Failing to value innovation



TO:

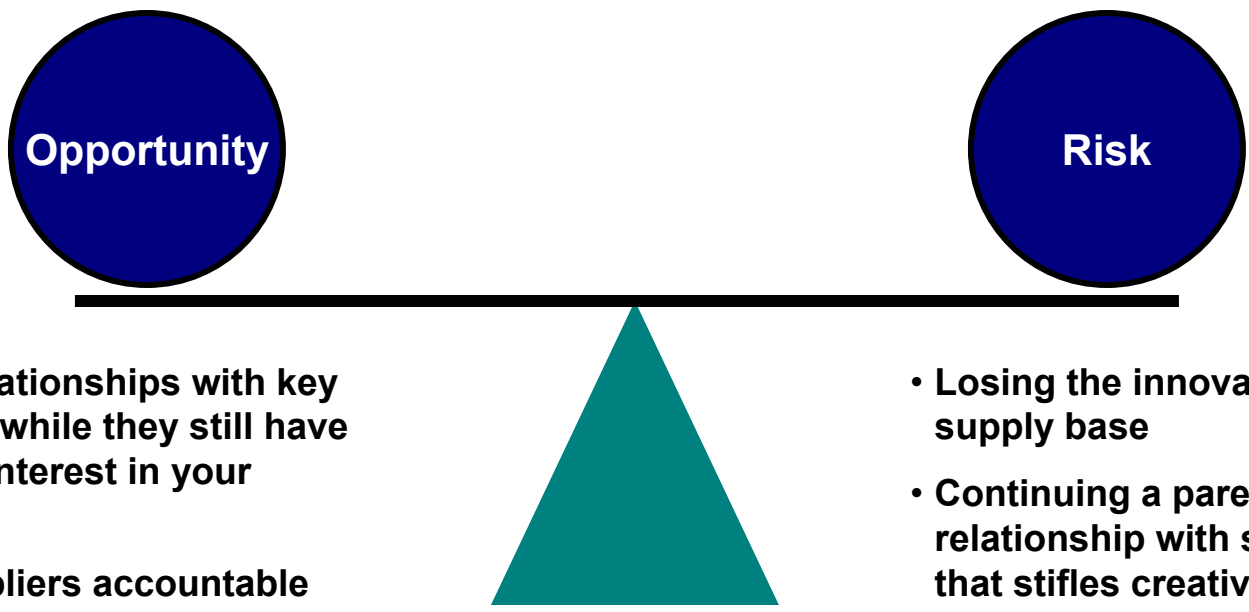
- More collaborative approach
- Systemic focus on cost reduction
- Focus on total cost
- More sophisticated program management
- Rewarding and protecting supplier innovation

Why the Japanese Value Chain is Winning

- **Consistency of Vision and Execution**
 - 4-8 core philosophies drive everything
- **A Focus On Cost Vs. Price**
- **An Understanding That the Cost of a Vehicle is Primarily Set in the Design Phase**
 - Current improvement target 20-30%
- **Dominance of Engineering and Manufacturing**
 - Depending upon the company, either engineering or manufacturing drive the key decisions
 - Most of the rest of the functions within the company, such as sales or finance, are viewed as supporting roles to the core functions of engineering or manufacturing

- **Dominance of Engineering and Manufacturing (cont.)**
 - As a result, product decisions are rarely sacrificed for short-term financial gain and product design and execution are much more integrated and seamless
- **It's the Product, Stupid**
 - The overall key to the Japanese success in the North American market in the last ten years has been their ability to design product the American consumer wants to buy (and buy again because of their experiencing few quality problems)
 - One of the reasons they do this so consistently is the effectiveness of their program launch process and their ability to provide a high degree of product customization at mass market pricing

The Opportunity and the Risk for the Big Three



- Repair relationships with key suppliers while they still have a vested interest in your success
- Hold suppliers accountable for performance but hold yourselves accountable as well
- Create opportunities for dialogue vs. one way communication
- View long term success as a systems issue

- Losing the innovation of the supply base
- Continuing a parent child relationship with suppliers that stifles creativity
- Waiting to change behavior until key suppliers are more diversified

- **Give yourself a choice. Customer diversification allows you to control your destiny.**
- **Support progressive initiatives at the Big Three. There are significant pockets of progress.**
- **Identify your key competencies and work to build competitive barriers to entry.**
- **Be very clear about your business design and avoid being seduced by new programs and volumes.**