

Understanding the health of your supplier: Is your company fuelled with working capital?



At a glance

With demand hard-hit by the recent recession, many suppliers restructured their operations and adjusted trade working capital to reduced demand levels.

Suppliers looking to increase production in response to improving market conditions may have capacity challenges and pressure on liquidity.

Suppliers, OEMs, and investors should consider benchmarking analysis of working capital requirements and developing strategies to better understand future liquidity prospects.

Understanding the health of your supplier network: Is your company fuelled with working capital?

Introduction:

With demand hard-hit by the recent recession, many suppliers restructured their operations and adjusted trade working capital to reduced demand levels. As a result, suppliers now looking to increase production in response to improving market conditions may have capacity challenges and will often need to finance in advance significant shares of their purchases, putting pressure on liquidity. Thus, OEMs and suppliers need to understand and respond to the resulting risks for their supply chains or investments.

cash patterns. These variations can have major impact on a risk assessment since the evaluation of currently available liquidity and future cash requirements may differ significantly depending on the business model of the analysed supplier.

In this article, we look at the impact of the recent market developments on working capital requirements and highlight some of the different trends observed across segments. We also describe the advantages of using benchmarking analysis when considering liquidity patterns and working capital requirements. Thus,

Those suppliers that survive the initial phase of an improved market with a solid liquidity cushion could have the financial flexibility to benefit from the recovery afterwards and the opportunity to gain a considerable competitive advantage.

While traditionally risk management has focused attention primarily on major suppliers, small and mid-sized suppliers can also represent a key element in the supply chain. These small and mid-sized suppliers may have more limited financing resources and other levels of working capital provision than larger players, and correspondingly higher risk profiles. Our working capital analysis shows that different segments of suppliers have different

identifying and including companies of the relevant segment within the benchmarking base is critical to understanding and assessing the overall risk levels of a specific company. Finally, we provide some strategies for suppliers, OEMs, and investors looking to better understand the future liquidity prospects of their companies and competitors, supplier base, or potential investment targets.

The economic crisis: Full speed to hard brake

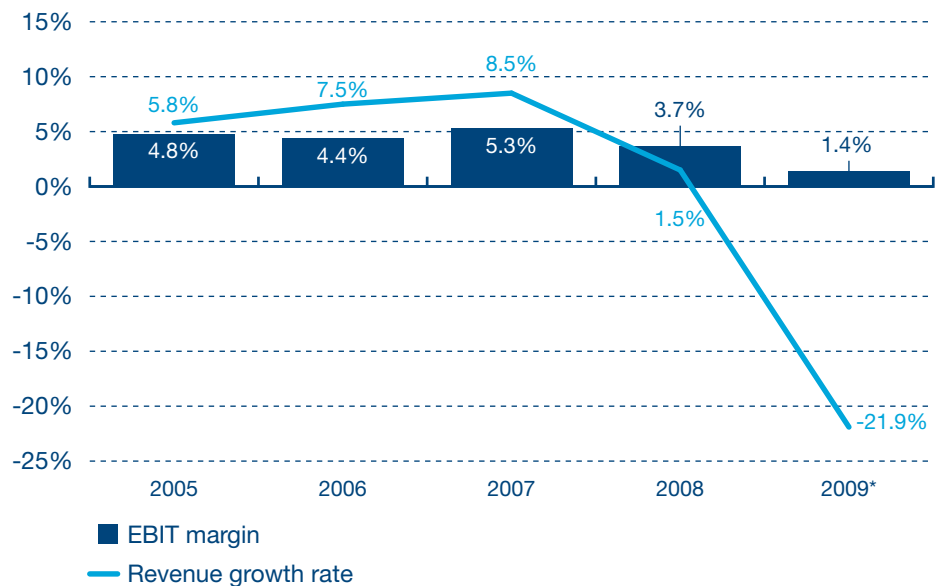
The global recession had a massive impact on the automotive industry. In Germany alone, more than 100 suppliers filed for insolvency. Across the Atlantic, two of the so-called Detroit 3 OEMs, General Motors and Chrysler, went through bankruptcy that impacted many of their suppliers.

The impact of the crisis on the P&L was dramatic. Operational profitability of European suppliers fell by more than 70% between 2007 and 2009, from 5.3% to 1.4%, representing the steepest decline in the past five years (Figure 1). Revenue growth came to a virtual halt in 2008, with an increase of just 1.5%, and collapsed in 2009, as revenues declined 21.9%.

While the downturn had a negative impact on all segments of the industry, some suppliers were less able to weather the crisis than were their industry peers. Service providers in particular, such as engineering companies, experienced a decline in profitability of almost 6% from 3.7% to -1.9% in 2009 (Figure 2). When the crisis began, OEMs and tier-1 suppliers limited their outsourcing of development projects and contracting third parties. As a result, order books of service providers dried up after the completion of ongoing projects in 2009.

The US market was the first to be hit by the economic crisis in 2007, although the downturn quickly spread to European and Asian markets during the course of 2008. Consequently, European suppliers with a major share of their business coming from the US market generally experienced a greater decline in EBIT in 2008 than did those with a strong focus on the European Market. Our analysis shows that small and medium sized companies experienced the smallest impact on margins, possibly as they tend to have a smaller global footprint.

Figure 1:
EBIT margin and revenue growth rate
Median, in %



Source: PwC SupplierFacts

*2009 based on set of 61 selected suppliers

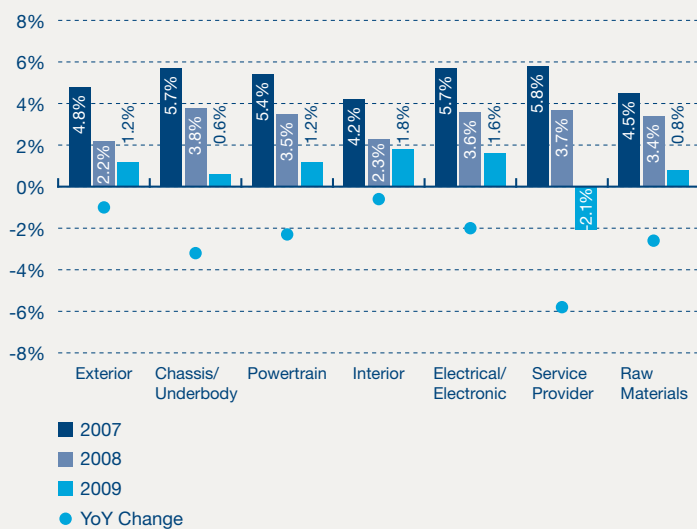
Scarce liquidity: Running out of fuel?

In order to preserve liquidity, many companies looked to reduce investments and began reassessing projects in research and development (R&D). This strategy was only able to offer limited potential savings, as projects in progress were usually finished to minimise sunk costs. As a means to increase liquidity, this strategy is generally more effective over the mid rather the short-term. Given the precipitous drop in demand and the difficulties inherent in cutting on-going projects, it is not surprising to see an increase in the relation of CAPEX to revenues in 2008. In 2009, as more programs drew to a close, the level of investments bottomed out, with CAPEX averaging a mere 4.1% of revenues.

While the need to free up cash may have been paramount for some, cutting R&D can be a risky strategy. Demand trends are shifting and technology is changing rapidly, so suppliers that cut back too significantly on programs which drive innovation risk losing their competitiveness. Further, new regulations are creating increased technical demands on the industry. Suppliers and car manufacturers may need to return to a higher level of investment in the medium term to keep up with changing demands impacted by regulation and competition.

Figure 2:

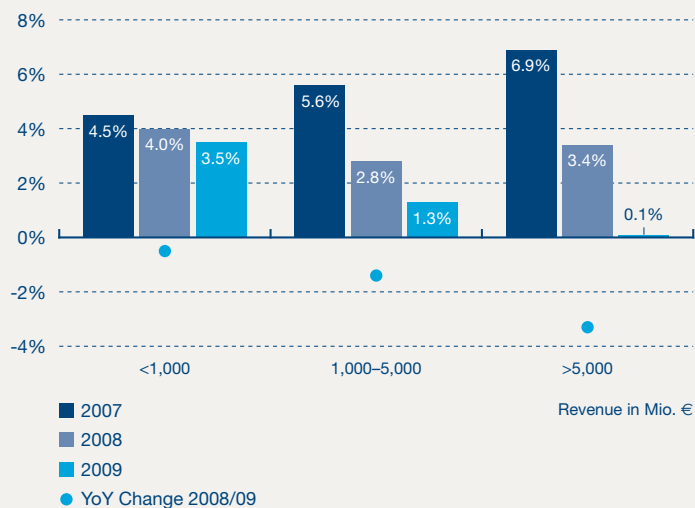
EBIT—Margin by sub segment
Median, in % of revenue



Source: PwC SupplierFacts

Figure 3:

EBIT—Margin by size
Median, in % of revenue



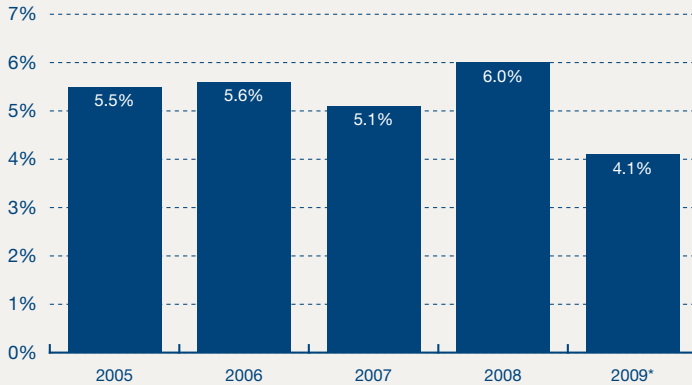
Source: PwC SupplierFacts

*2009 based on set of 60 suppliers

Figure 4:

CAPEX

Median, in % of revenue

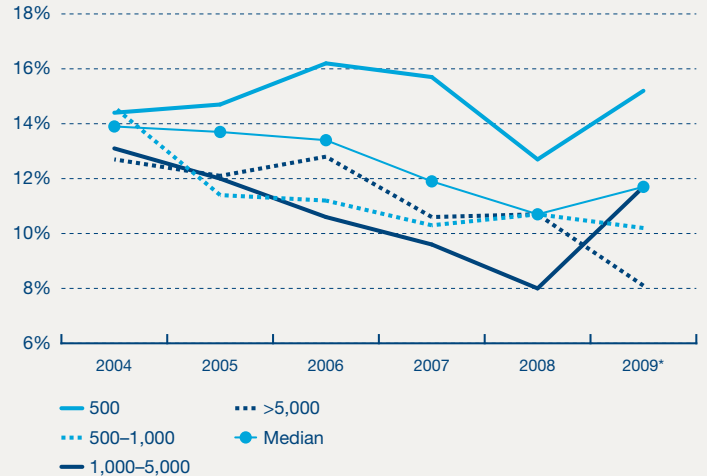


Source: PwC SupplierFacts
*2009 based on set of 60 selected suppliers

Figure 5:

Working capital to sales

Median, in % of revenue



Source: PwC SupplierFacts
*2009 based on set of 30 selected suppliers

Many companies viewed working capital as another feasible source of liquidity. Facing zero or negative growth, working capital was quickly adjusted to the new levels of demand, and unrealised reserves to cover operational liquidity demand were released.

As a result, net working capital was reduced to a level below the average in periods of economic growth and stability. Working capital to sales was reduced from 13.4% in 2006 to 10.7% in 2008. This drop is effectively a 20% decline and represents 2.7% of revenue. The impact cannot be overstated—the liquidity achieved from working capital reduction equals 45% of the capital expenditure in 2008 or 30% of the average EBITDA of the European supplier industry. In 2009 suppliers continued to draw upon working capital as a key source of liquidity, however, due to the speed of the revenue decline the levels of working capital could not be adjusted simultaneously.

Furthermore, the first signs of recovery at the end of 2009 resulted in a restocking. This is reflected in the year end values of working capital of the analysed suppliers.

A characteristic of the economic crisis was the limited access to external financing via established sources such as banks and capital markets or equity investors due to the high degree of uncertainty and disrupted global capital flows. Small suppliers in particular tend to have limited access to capital markets and often had to rely on internal sources of financing. Our analysis shows that the group of suppliers with less than m€ 500 revenue were able to reduce working capital between 2007 and 2008 more than their larger competitors; however, with a ratio of 12.7%, the working capital of this group of suppliers is still above the average. In 2009 the suppliers had to restock partially, but nevertheless working capital remained below pre-crisis levels.

First signs of an upswing

Some signs of hope for an improving economic outlook and a recovery in automotive demand can be seen: in the emerging markets of India and China, demand showed a strong jump in August 2010; demand in India was up +34%

many industry observers expect decreasing sales volumes as such initiatives come to an end in most countries.

Markets in Eastern Europe and Russia are still behind the registration levels seen before the crisis.

in August and in China demand increased +37% YoY in August. In May 2010 Moody's Investors Service upgraded the outlook for the global automotive industry to positive, and mature markets such as the US posted more stable sales than expected in the first quarter of 2010. However other major markets remain unpredictable. In Western Europe, demand for passenger vehicles was propped up by scrappage schemes in 2009 and

Recovery would certainly be preferable to further stagnation or decline; however, increasing demand also implies certain near-term risks. Following a period of low or negative earnings and limited access to financing, due to the restrictive lending policies of banks, suppliers and car manufacturers may have tapped every remaining source of liquidity. Many suppliers may need to reassess their working capital policies to ensure that these are able to respond to market trends.

Acceleration needs fuel

Optimisation of working capital is generally considered essential for a lean and efficient management of companies. Improving capital efficiency and thus capital charges remain one of the main issues for operational management. But what does the observed reduction of working capital mean? And what are the implications for supplier and manufacturers as well as banks and investors?

In the wake of the recent economic crisis, even small companies are actively addressing these questions and working capital management has become a focal point of

with suppliers were maxed out or renegotiated. Occasionally, car manufacturers agreed to settle trade liabilities earlier to support their supply base. For example, a German OEM decided to pay its suppliers earlier at the end of 2009, eliminating a major share of trade receivables—and thus working capital—of the OEM's suppliers.

Such measures only offer a stop-gap solution. If demand for passenger cars and commercial vehicles normalises, levels of working capital is expected to revert in the direction of the levels seen before the crisis.

While in general the recent reduction in working capital levels is positive, companies may want to ensure that they watch their liquidity closely and to remain financially flexible to cover increased liquidity demands when growth returns.

interest for nearly every enterprise. This renewed attention has led to the uncovering of hidden reserves and the optimisation of processes and stocks. In the long run this could result in a leaner organisation, less capital requirements and additional value for shareholders.

Indeed, the current levels of working capital at suppliers are not likely to be sustainable. In the search for liquidity, terms of payment

This could have a double impact on the liquidity of suppliers. Suppliers may experience an immediate cash outflow due to the additional working capital requirements of their current level of revenues. Further, an increase in demand could result in the need to allocate additional capital to working capital reserves in order to finance the additional revenue growth.

Assuming that automotive suppliers return to a normalised level of working capital to revenue from 11.7% at the end of 2009 to the average of about 13.2% for the European supplier industry, working capital could need to grow by approximately 28.1% in 2010 compared to 2009.

Many of the key forecasting parameters remain difficult to predict, so projections for 2010 still reflect some uncertainty. In this light, the PwC Autofacts Group expects global assembly to be 68.7 million vehicles in 2010.

Smaller sized suppliers may experience even greater challenges. In general they have less negotiating power and are less likely to be able to dictate conditions to other suppliers and car manufacturers. Smaller suppliers also showed the highest net working capital reduction in comparison to larger suppliers, and they may experience a strong rebound effect. And while we have seen impressive success in 2008 and 2009 regarding the reduction of working capital, the working capital management processes at small sized suppliers are still less robust and well

established than those of their larger counterparts. Thus, they may be more sensitive to growing demand.

Despite growing revenues, profitability may remain low. Pre-crisis production levels are not expected to be realized for some time, while global assembly overcapacity could remain at a high level, particularly in Europe, putting pressure on car manufacturers to demand further price cuts from their suppliers. While investors and banks are likely to remain reluctant to finance automotive suppliers, and only medium to large sized suppliers may have direct access to capital markets, the quest for liquidity will remain on the agenda of automotive suppliers. Indeed, for many it may gain in importance and in some cases additional suppliers may face illiquidity.

Benchmarking as integral part of financial forecasting

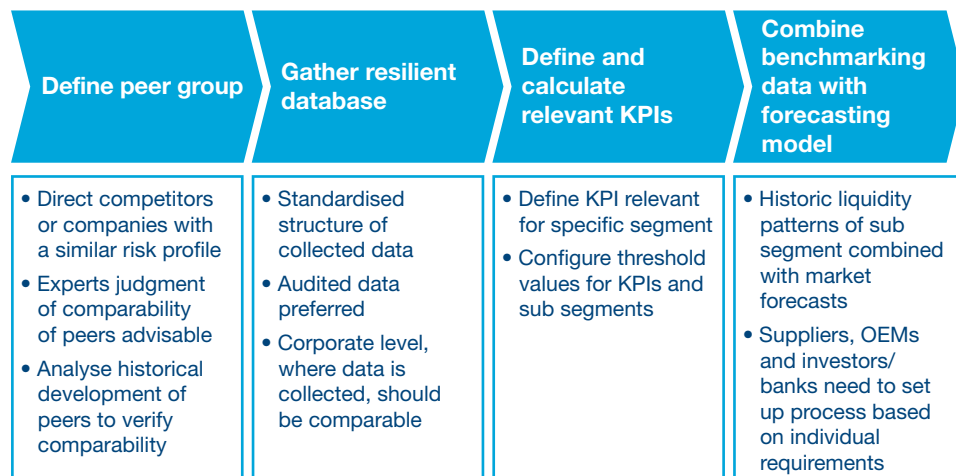
Many companies are aware of the patterns of working capital requirements when demand returns after a downturn, however, they may not have implemented sufficient tools to monitor and control the respective risks. Risks and countermeasures often vary depending on a company's position within the value chain.

Our analysis shows that working capital based liquidity patterns may vary significantly depending on the size of the company. But size is not the only determiner of liquidity requirements. Other factors that determine the supplier's business model such as strategy, global footprint and product and service portfolio are equally critical. It is obvious that each supplier could react individually on growing demand; however, certain suppliers with a similar business profile can

be grouped and benchmarked to reveal the liquidity pattern of the specific sub segment. To assess the risk of a specific supplier it is helpful to map the relative position and performance of the company, as well as its current and future liquidity requirements.

The benchmark for such evaluation of a supplier can be derived from a comparable peer group to provide realistic targets. For example, engineering service providers that have a high share of revenues from products that are compensated on a per part base, when the specific part is used in production of a supplier or OEM, generally have higher working capital requirements than those engineering service providers that focus on pre-production development such as prototyping. Thus, comparing the current or future cash requirements

Figure 6:
Implementing benchmarking in a risk management system



of an engineering service provider focused on the development of production parts with the working capital targets of prototyping focused service providers could result in an underestimation of future liquidity needs.

different products instead of direct competitors as part of the peer group.

To ensure a robust analysis, the historic performance of identified peer companies should also be

available—individual accounts for companies with no major subsidiaries.

Subsequently, meaningful key performance indicators (KPI) have to be defined. They may differ for

It is therefore essential to adjust the parameters and threshold values of a risk monitoring tool to peer group specific levels to assure a high level of reliability of the monitoring system.

The first step in implementing a benchmarking analysis as part of the risk management and forecasting system is the appropriate definition of a representative peer group. Direct competitors would seem to be the perfect fit, since they bear a comparable risk implied in the business model. However, “pure play” suppliers of a single product or product segment are the exception. If the targeted peer companies offer a similar product, however, it represents only part of revenues for some of these companies and the risk profile will differ. The same principle holds true for other factors such as size or primary customers. In some cases it might be more appropriate to use companies with similar business models but

compared to the performance of the focus company. This allows a comprehensive peer group with a representative business and risk profile to be identified.

Afterwards, resilient data of the peer group needs to be gathered in order to analyse performance. During this process particular attention should be paid to the following factors:

- Data should be gathered in a standardised structure to provide a comparable database;
- Audited financial statements should be used. Major differences in accounting standards should be eliminated or considered when data is analysed;
- Data should be collected on a consolidated level or—if not

the specific segments and should be chosen individually to measure the relevant value drivers of the business. Using the collected data, the historical values of the KPIs can be calculated and segment specific patterns identified.

Finally, the identified patterns should be combined with forecasting data to assess the risk of predicted market developments. While historic results will not be a guarantee for future trends, the identified patterns qualify as a suitable early indicator. Forecasts should focus on both the future development of the automotive market in general and the specific market of the focus company. External automotive industry production forecasts, in combination with macro and micro economic indicators, are a

good foundation for a forecasting system. Based on this data a market model can be derived for the relevant segment. Combining the projected market developments with the selected, identified cash flow patterns (e.g., working capital patterns) will render possible the calculation of how KPIs of the focus company are likely to be impacted by market developments.

The process of implementation of an efficient and reliable risk management system using historical data as well as forecasting data needs to be tailored to the individual needs of the addressee. Installing a benchmarking functionality in your risk management system may contribute significantly to the quality of the results. Suppliers, OEMs and investors should monitor the financial health of the supplier industry, but they face somewhat different issues, and will need to refine their models accordingly.

Suppliers face the risk of limited access to working capital financing in times of growing demand. Possible countermeasures include the following:

- Analyse and understand working capital requirements through industry cycles;
- Monitor working capital on a timely basis as one of the key KPIs for top management reporting;

- Continuously optimise and reduce working capital requirements;
- Implement an integrated cash flow forecasting methodology based on market projections, including working capital requirements;
- Consider results of integrated forecasting in the development of financing strategy and your communication with external creditors.

OEMs also face supply chain risk. While most OEMs monitor the bigger suppliers, small and medium sized suppliers, as well as tier-2 suppliers, can remain below the radar. Nevertheless, a default by a specialist supplier may cause major disruption in the supply or production process or even halt production. The following steps can help to reduce the risk for the OEM and increase transparency:

- Get access to selected, standardised financial data of own suppliers as well as selected, critical tier-2 suppliers (best in class processes may require critical tier -2 suppliers and those who supply time-critical parts or components to self-provide this information on a regular basis);
- Categorise suppliers to pre-defined sub segment with individual industry pattern (e.g., electronic supplier, engineering service provider, etc.);

- Continuously benchmark data with respective peer group to monitor relative performance;
- Simulate liquidity risks based on forecasted market development and sub-segment industry patterns.

Investors face the risk of mispricing a potential investment in the pre-deal phase. Once they have invested, they may end up losing the investment or needing to inject capital into a troubled investment due to a misinterpretation of future capital requirements. These concerns also apply to **banks and other creditors**. The following steps could help to reduce such risks:

- Compare historical capital development with peer group to assess performance of the company;
- Reflect future business plan with historical benchmarking data to validate plausibility;
- Simulate cash requirements based on industry patterns and assumptions regarding market development;
- Derive impact of cash requirements on return on investment and debt service.

Gentlemen, keep your engines running

While the worst of the economic crisis may be behind us, major risks for all participants in the automotive value chain lie ahead, even if demand recovers. For this reason, suppliers, OEMs, investors and creditors should consider further focus on liquidity issues. They could benefit from understanding the industry patterns for each relevant sub segment, including capital requirements driven both by working capital and by future CAPEX needs, which may have to increase to pre-crisis levels in order to keep up with the technological progress of the industry. Simply

understanding the numbers may not be enough, though. Automotive players also should consider having access to sound forecasting that helps anticipate changes in demand. Combining financial benchmarking with an integrated forecasting methodology can provide a sound analytical basis for decision making.

Those players that survive the crisis and the initial phase of an upswing with a solid liquidity cushion may have the financial flexibility to benefit from the recovery afterwards and the opportunity to gain a considerable competitive advantage.

More about the *SupplierFacts* Benchmarking Tool

We analysed the influence of the crisis with our *SupplierFacts* Benchmarking Tool to understand the implications on the financial performance of suppliers and to identify major risks for suppliers, car manufacturers and investors, as well as external creditors. We drew upon the annual reports of almost 200 European automotive suppliers for the period 2004-2008 to create a historical dataset. For 2009 we analysed a set of 60 automotive suppliers with a global footprint.

To have a deeper conversation about any of the issues in this paper, please contact:

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