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Smart Bets for
Auto Suppliers
*Transforming
Underperformers into
Advantaged Players*



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EXECUTIVE SUMMARY

In the midst of the auto industry's deepest downturn in decades, automotive suppliers are in a fight for their survival. The dramatic decline in volume has put ever more severe pressure on already depressed margins, driving many suppliers into bankruptcy and putting dozens more on the brink.

The postrecession auto industry will look far different from today's, with fewer suppliers and much more focused business models for those that remain. To survive, suppliers must place their bets now, backing the business units that fit well strategically and have the potential to create sustainable, advantaged market positions. No longer can suppliers afford to subsidize weaker business units with no clear right to win.

This Perspective discusses the importance of making strategic bets and how suppliers can ensure that the bets they make are smart ones. There is no time to waste. Place your bets now, and begin the hard work of fixing the potential winners. In the current market, succeeding at this task may mean your very survival.

THE DARKEST HOUR

By now the problems confronting the automotive industry are all too clear. Thanks to a perfect storm of factors—the housing slump, the collapse of the capital markets, the freezing of consumer credit, and the decline in consumer confidence—vehicle sales have plunged. For the first quarter of 2009, sales declined by almost 40 percent compared with the already depressed levels of the year-earlier quarter, driving per capita sales in the quarter to the lowest level since the recession of 1958. Though the government aggressively intervened

to help the Detroit Three weather the storm, initial efforts fell short, with both Chrysler and General Motors falling into bankruptcy. Even Toyota has not been immune from this current crisis, reporting an operating loss of close to US\$4.5 billion for 2008, and a loss of nearly \$8 billion in the first quarter of 2009, surpassing even GM's net loss of \$6 billion for the same period.

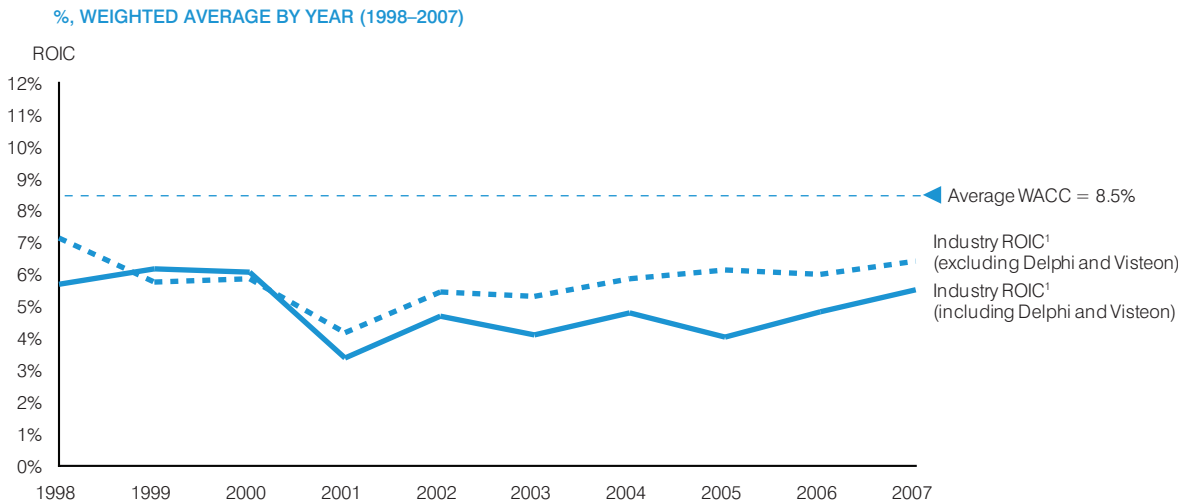
Though the effects of this crisis are widespread, few sectors have been affected more than automotive suppliers, many of which have historically struggled to earn their cost of capital even when times were good (see Exhibit 1).

The challenges are great. Developing the capabilities needed to successfully compete typically requires scale,

whether in product development, manufacturing, or purchasing. Yet it is this very quest for scale that too often has resulted in unintended consequences, with some suppliers venturing into new markets where there was little room for them to play and where their right to win was questionable at best. This, combined with the emergence of new foreign entrants and rapid gains in productivity, has helped to widen significantly the mismatch between supply and demand—even before the recent collapse in sales volume.

Though the first signs of a recovery have begun to emerge, the headwinds confronting automotive suppliers are still great. In testimony before the U.S. Congress earlier this year, the CEOs of the Detroit Three forecast that U.S. light vehicle sales

Exhibit 1
Return on Invested Capital (ROIC): Leading Automotive Suppliers



(1) Includes Aisin Seiki, American Axle, ArvinMeritor Inc., BorgWarner Inc., Calsonic Kansei Corp., Continental AG, Cummins Inc., Dana Corp., Delphi Corp., Faurecia, GKN PLC, Johnson Controls Inc., Lear Corp., Magna International Inc., Martinrea International Inc., Robert Bosch GmbH, Tenneco Inc., ThyssenKrupp AG, Toyota Boshoku Corp., TRW Automotive Holdings Corp., Valeo SA, Visteon Corp.

Notes: 5-year betas were used for WACC calculation; Weighted Average ROIC = $\sum(\text{ROIC}_i \cdot \text{Invested Capital}_i) / \sum(\text{Invested Capital}_i)$; ROIC = After-Tax Operating Profit / Invested Capital; After-Tax Operating Profit = $(1 - \text{Tax Rate}) \cdot (\text{Revenue} - \text{COGS} - \text{SG\&A})$; Invested Capital = Total Assets - Non-Interest Bearing Current Liabilities; Tax rate of 35% assumed for all companies; Companies in which data not given for all 10 years: ArvinMeritor (starting 2000), Robert Bosch (starting 2001), ThyssenKrupp (starting 1999), Toyota Boshoku (starting 2000), TRW (starting 2003).

Source: Bloomberg; Capital IQ for WACC calculation; Booz & Company analysis

would hit a low of about 10 million vehicles in 2009, well off their peak of 17 million vehicles in 2005. Already a number of suppliers have entered into bankruptcy, with many more on the brink. Though the government unveiled a rescue package of \$5 billion to guarantee receivables, it is far short of the \$18.5 billion initially proposed, and not nearly enough to address the industry's systemic weaknesses and overcapacity. And unlike in years past, suppliers can no longer hold out for the promise of being rescued by their peers, customers, or investors hoping for a good return.

Emerging from this turmoil will be an automotive industry that looks far different from today's, with fewer suppliers and much more focused business models for those that remain.

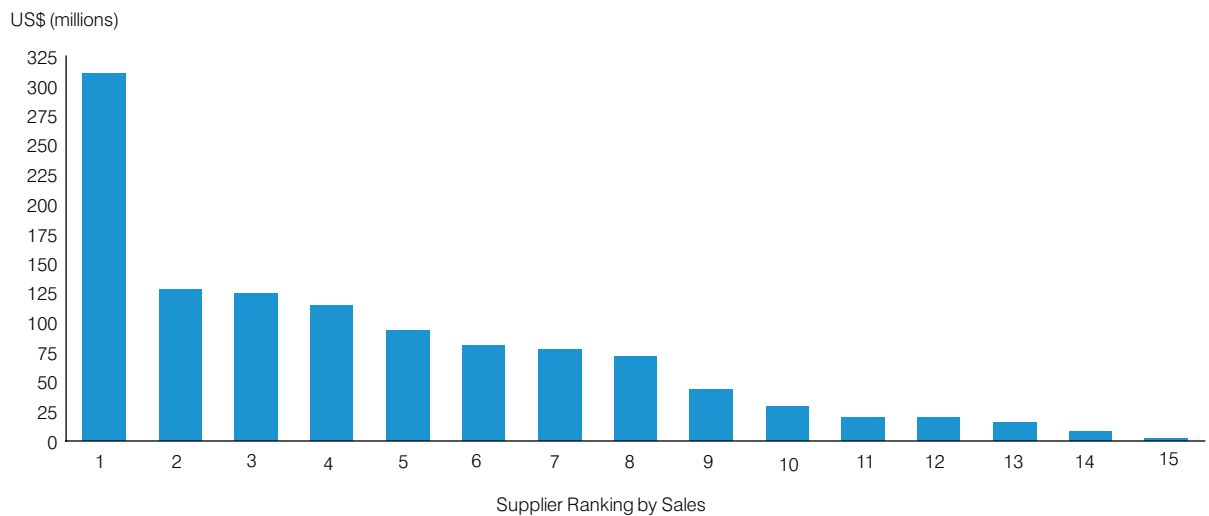
Simply put, it's a numbers game. For any given market, there is a natural number of suppliers that can be supported, with the exact number dependent on the capital and fixed-cost requirements needed to enter and the ongoing production economics needed to compete. In recent years, as the mismatch between supply and demand has grown, and with pressures on margins building, the upper limit of how many suppliers the auto industry can support has been severely tested—often with unfavorable results, as our ROIC analysis and the many bankruptcies show.

A good illustration is the North American seat adjuster market (*see Exhibit 2*). In 2007, 15 suppliers served a market worth approximately \$1.1 billion. Unless the smaller players on the tail of the curve are able to find a defensible niche position with

pricing power or decide to subsidize their marginal position in seat adjusters with their other businesses, it is difficult to envision how they can carve out a long-term sustainable position—especially given the sudden decline in volume. The challenges are simply too great. Of course, a technological breakthrough might provide just such a path, but in seat adjusters, the likelihood is slim.

As markets continue to shrink and resources become increasingly scarce, auto suppliers can no longer afford to subsidize weak businesses, especially those with little or no strategic value and limited potential to be transformed into advantaged players. Executives need to free up resources and deploy them to those business units where they can best be put to work. Now more than ever, it is a time to focus.

Exhibit 2
The North American Seat Adjuster Market (2007)



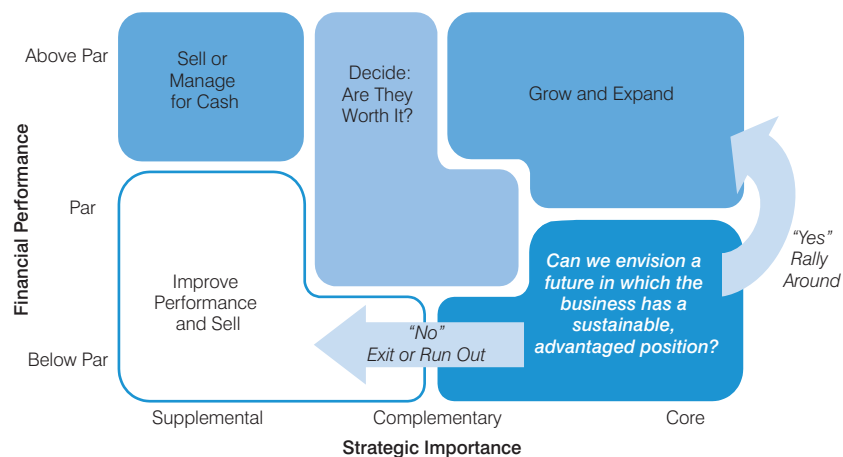
Source: CSM Worldwide; Booz & Company analysis

MANAGE THE PORTFOLIO

The vital challenge, of course, is deciding where to focus and which businesses to rally around. There are two critical axes by which a business unit should be evaluated. The first is the financial performance of the unit; here, return on invested capital is the key metric. The second is the strategic importance of the business unit to the overall enterprise

(see Exhibit 3). In our experience, companies are most successful when their capabilities are both coherent and consistent across the portfolio. If the success of a business unit demands capabilities that are not consistent with the broader enterprise, that unit should not be considered strategically important.

*Exhibit 3
Mapping the Portfolio*



Source: Booz & Company analysis

In most cases, the portfolio map makes deciding what to do with a business unit relatively easy. Business units in the upper right corner are the clear winners; reinvest in and aggressively grow them. Business units that fall in the upper left corner are also strong performers, but not a strategic fit with the broader enterprise. Because they are strong performers, they are likely to attract a fair value in the marketplace, so consider divesting them.

The lower left corner represents business units that are both underperforming financially and not a strategic fit with the company. If they can be sold for a fair value, sell them. Given their performance, however, that might be difficult, so consider running them out for cash.

Deciding what to do about the business units that are strong performers financially—yet are ones in which some doubt exists as to

whether they are a strategic fit—is relatively straightforward from a logical perspective, if somewhat more difficult to execute. Ask these questions: Is another company likely to value this business unit more than we do? Are the capabilities required to sustain it consistent with the enterprise? Would I be willing to make a significant investment in this business unit to move it to the upper right corner? If you cannot answer yes to all three questions, then sell.

In our experience, companies are most successful when their capabilities are both coherent and consistent across the portfolio.

PLACE YOUR BETS

It is the businesses in the lower right corner—the ones that are of core strategic importance but have historically underperformed—that present both the greatest challenge and a major opportunity.

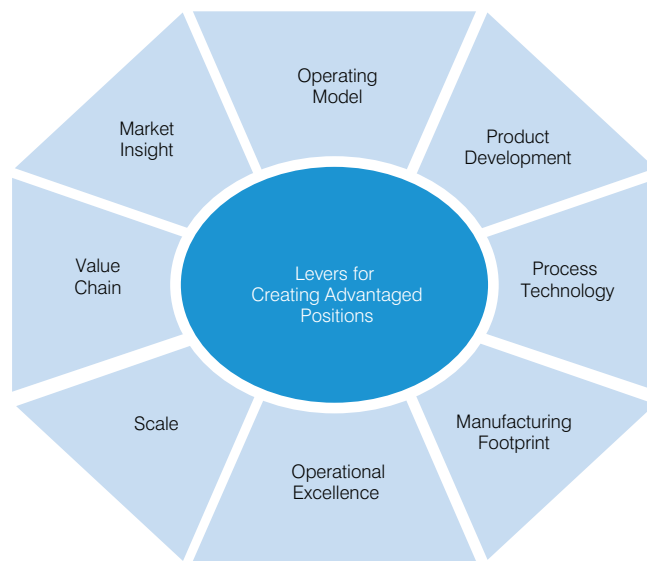
If they can be fixed, these businesses offer the potential to provide tremendous step-change improvement in your company’s financial performance and strategic position. If you hold on to them without fixing them, they will continue to be a drain on resources, preventing the company from realizing its full potential—and possibly putting its very existence at risk.

So here’s the critical question: Which of these businesses should you place your bets on? At the most basic level,

first ask, can I envision a future in which the business has gained a sustainable advantaged position? In other words, do I have a right to win with this business? This is not the same thing as asking whether the business can be made “competitive.” Being competitive just puts you in the game; being advantaged is what makes you money.

What does it mean to be in an advantaged position? It means clearly understanding a specific market need and meeting that need in a superior, differentiated way relative to the competition. How you achieve this advantage, and the actual levers you use, will vary (*see Exhibit 4*). It all depends on your customers’ needs and what they’re willing to pay for; in

*Exhibit 4
Levers for Creating Advantaged Positions*



Source: Booz & Company analysis

some cases it might be cost, in others it might be value or time—in other words, how the market segments.

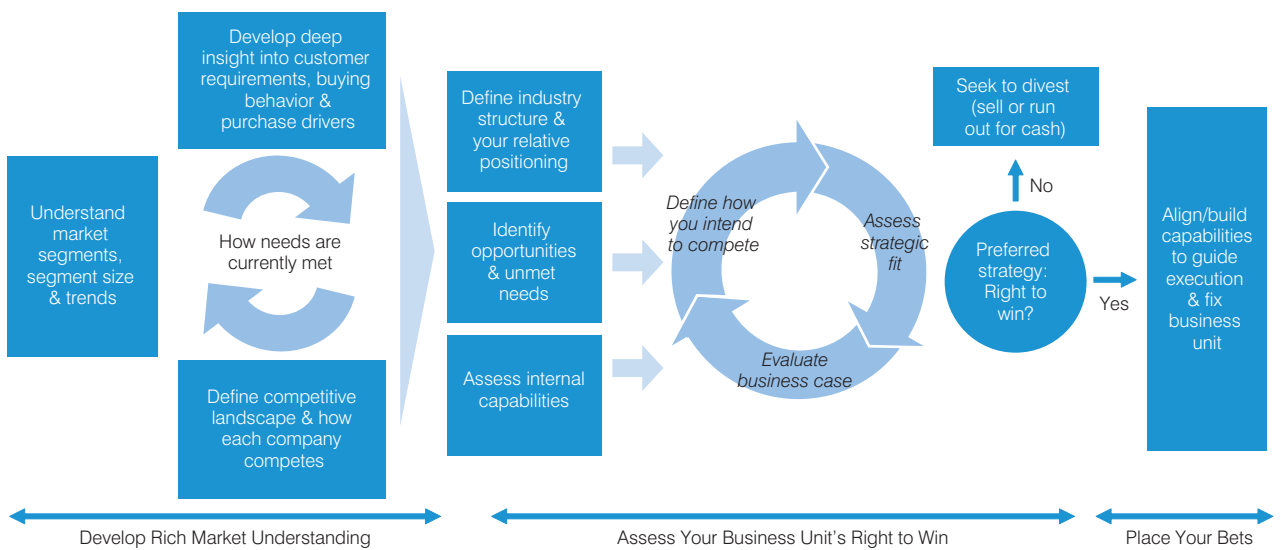
Just as important, an advantaged position is one that can be defended and hence is sustainable. To this end, a certain level of paranoia is always healthy. Do not confuse the ability to earn a profit today with having a truly advantaged position. Continuously challenge yourself to define what a competitor might be able to do differently to attack your position and put your profit stream at risk. If your company can be the first to define and exploit that potential opening, it can be the first to claim it.

No matter how a business unit achieves an advantage, that advantage must also be substantial from the perspective of what the OEM is willing to pay for. The typical OEM buying criteria, such as quality and delivery, certainly matter, but they earn suppliers only the right to enter, not the right to win—to make money in the long term. In reality, experience shows that OEMs are willing to pay for just four things: demonstrable reductions in original equipment costs through, for instance, lower logistics or lower system engineering costs; greater fuel economy; the ability to generate interest on the part of end customers; and a solution to a specific program issue. Unfortunately, all too often, we have seen business units fall

into the trap of “technical greed”—more sophisticated technology is always better—and in the process destroy shareholder value by chasing engineering marvels the market will never reward.

Only by performing a market-back assessment—beginning with a systematic analysis of customers and their needs and then considering whether your business has the capabilities and the business potential to succeed in that market—can you make confident decisions about the strategic direction of the business. Making smart bets depends on how honestly, and how quickly, you perform this task (*see Exhibit 5*).

Exhibit 5
Making Smart Bets



Source: Booz & Company analysis

START THE JOURNEY

The current environment is putting, and will continue to put, intense pressure on all automotive suppliers. For years they have struggled to earn their cost of capital, and the battle has just gotten harder. The game has changed, and it is time for suppliers to confront the industry's new realities or risk being consigned to the dustbin of history.

No longer can suppliers afford to keep subsidizing weak businesses that have no clear right to win. Now is the time to take strong, decisive action—to make choices and place bets, and, most important, to place them wisely.

Placing the right bets, however, is just the start of the journey. Migrating a business unit from underperformer to advantaged player will not happen overnight. Getting to know the market and its needs intimately—putting in place the right footprint, the right capabilities, and the right products—takes time, resources, skill, and great discipline. But make no mistake: Every successful turnaround must begin with a business unit worth fixing. If it has a right to win, it has a chance. If you can place smart bets, and in so doing shed your losers and rally around your winners, you might just emerge from this crisis stronger than before.

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