FTI CONSULTING™

Crisis as a Catalyst for Change

Focusing on operational and financial discipline in the wake of COVID-19

Part 1 of 3 articles

In partnership with the Automotive News Data Center

Even before COVID-19 brought travel, tourism, hospitality and many other industries to a screeching halt, signals were emerging that the automotive industry was headed into a slowdown. After a decade of record sales and financial performance, global automotive sales hovered around 91 million units in both 2017 and 2018 and began sliding in 2019.[1]

Other forces were also at play, signaling that the automotive value chain was undergoing a massive transformation of its technology and business model. Consequently, where value was created and how enterprise performance was driven were also shifting.

Automotive suppliers had enjoyed record volumes between 2010 and 2017 and steady returns against three key performance indicators (KPIs): Revenue growth, return on invested capital (ROIC) and earnings before interest, taxes, depreciation and amortization (EBITDA).

But according to an FTI Consulting (FTI) analysis of 404 auto suppliers, growth and financial performance declined in 2018-19 (Figure 1).

Figure 1: Supplier KPIs (2010-17 vs. 2018-19)

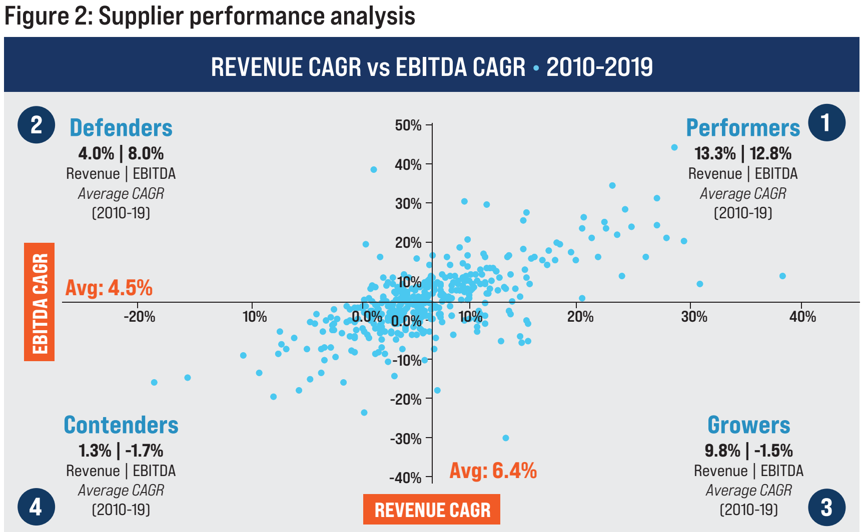
Revenue CAGR		EBITDA CAGR		ROIC Year-end*	
2010-17	2018-19	2010-17	2018-19	2017	2019
7.43%	3.00%	2.18%	1.84%	11.33%	8.60%

Note: *Compound annual growth rate (CAGR)*
Source: *S&P Capital IQ and FTI Consulting analysis*

* ROIC is year-end of 2017 and 2019, respectively

FTI's analysis also revealed that even during the record industry volumes coming out of the 2008-09 recession, supplier performance was clearly differentiated. Suppliers fell into one of four quadrants based on their performance on revenue growth vs. EBITDA KPIs (Figure 2).

Figure 2: Supplier performance analysis



Source: *S&P Capital IQ and FTI Consulting analysis"*

Nearly 75 percent of suppliers fell into the Performers and Contenders quadrants of FTI's analysis. During the performance slowdown cycle from 2018-19, Performers (above average revenue and EBITDA growth) saw a 17 percent reduction in ROIC while Contenders (below average revenue and EBITDA growth) saw 27 percent reduction. Contenders, however, were also able to grow EBITDA margins. Defenders (above average EBITDA growth) stood out the most in FTI's analysis. That group saw the smallest decline in ROIC between 2018-19 and increased EBITDA margins. Growers (above average revenue growth) appear to have struggled according to the analysis. Growers' ROIC dropped 78 percent as a result of declining EBITDA – worsened by a large drop in growth.

Executive views on driving operational and financial performance

The pandemic has brought into focus the operational and financial health of automotive companies and is requiring their leaders to rethink the strategic levers that will allow them to weather COVID-19 in the short term and position their companies for strong longer-term performance at volumes that are likely going to be lower for the next 18-24 months.

Foremost among the concerns shared by nearly 20 executives interviewed by FTI and the Automotive News Data Center for the "Crisis as a Catalyst" series were employee safety and immediate changes required to comply with health guidelines. Beyond that, a set of themes emerged among executives that offers insight into how they are thinking about changes to the operational and financial cost structure in response to the risks COVID-19 has exposed.

Short-term liquidity and longer-term changes to capital structure

Executives were consistent in their views on cost and capital structure. They felt confident about short-term liquidity and the capital they had already accessed or were able to access, particularly given the quick onset of COVID-19.

Longer term, however, many felt capital structure for some suppliers would be exposed and likely need to change, particularly among suppliers with high fixed costs and capital needs that also have a concentrated portfolio of customers. While most agreed that allocation of capital would likely change over the next 18-24 months, there was little concern surrounding the flow of capital. They did think COVID-19 had reminded business leaders that parts of the global supply chain are not well-positioned to withstand jolts to the system, something one executive described as "familiar" – referring to similarities to the 2008-09 recession. Many also voiced concerns about how companies were raising expensive debt to improve their liquidity cushion and how that would affect interest costs and balance-sheet health. The most significant concern noted was how delays in capital expenditures might affect their competitiveness beyond 2021.

Resiliency and cost of a global supply chain

Executives almost unanimously noted how the pandemic had revealed risk in a global supply chain. Most noted that the near-term focus was minimizing potential disruptions up and down the supply chain as operations resume and demand grows. Some noted going-concern risks with sub-tier suppliers that they were actively working to mitigate.

Perhaps most interesting among some of the discussions was a feeling that the cost and risks of a global offshore supply chain might be getting too high, and it might be time to rethink low-cost sourcing strategies that may no longer create a competitive cost advantage when factoring in risks the coronavirus had exposed.

Said one executive: "There are those who have not been strategic and have gone to China for price, although they have not factored in a risk premium. They're going to see that exposure and are going to have to rethink it."

Investing in people, process and productivity

Executives consistently noted that they were preparing for a new reality where fewer workers would be able to collocate in the same area and capital investments in digital technologies and automation would likely be required to maintain operations and production. Concerns were noted about higher absenteeism because of the continued spread of COVID-19 and the need to ensure operations can continue. Some executives also thought that coupled with the capital expenditures related to new digital and automated solutions, there needed to be an assessment of skills required to operate those solutions, something that might also affect their talent strategies. Not surprisingly, they were also consistent in their optimism that regardless of the near-term bumps in the road, the challenges surrounding people, digital and automated processes and productivity will be met.

What's at stake?

Assuming 15 percent lost revenue and a 20 percent increase in operating costs, FTI's analysis reveals that some companies could see a 10.5 percentage point decrease in ROIC if additional cost reductions and efficiency improvements are not implemented (Figure 3).

Figure 3: EBITDA impact example

P&L	Base Case (MM)	Scenario (MM)
Revenue	$100	$85
Less: Material COGS	($60)	($51)
Less: SG&A/expenses	($30)	($30.6)
EBITDA	$10	$3.4*
Invested Capital	65.1	66.4
ROIC	8.6%	(1.9%)

* A $6.6MM loss in EBITDA is a result if no action is taken operationally due to COVID-related disruptions

Source: *S&P Capital IQ and FTI Consulting analysis*

Conclusion

Auto companies have always been pressured to reduce costs. Naturally, some companies lose the focused discipline, particularly in growth cycles. FTI's analysis is a reminder that it is imperative for suppliers to take another look at more efficient ways of doing business and maintaining cost discipline over the long term.

In part two, we explore crisis as a catalyst for change to companies' innovation agenda.

To learn more about FTI's analysis of automotive suppliers, contact:

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[1] Automotive News Data Center analysis