Pulse Check

Status of the Automotive Supplier Industry

Results from third survey

October 21, 2019

CLEPA
European Association of Automotive Suppliers

McKinsey & Company

Your McKinsey team behind the CLEPA McKinsey Pulse Check

Dr. Andreas Cornet
Senior Partner

Global leader of McKinsey's automotive supplier sector

25+ years of experience within the automotive industry

Dr. Dirk Breitschwerdt
Senior Partner

Leader of McKinsey's automotive supplier sector in EMEA

15+ years of automotive experience, focusing on automotive suppliers

Dr. Lukas Michor
Partner

Co-Leader of McKinsey's automotive supplier sector in EMEA

9+ years of experience, supported 10+ automotive suppliers

Benedikt von Bary
Senior Associate

Responsible project manager for the CLEPA McKinsey Pulse Check

Focus on automotive and automotive supplier industry

Areas of insight

+ Possibility to analyze changes in industry sentiment by comparing semi-annual survey results

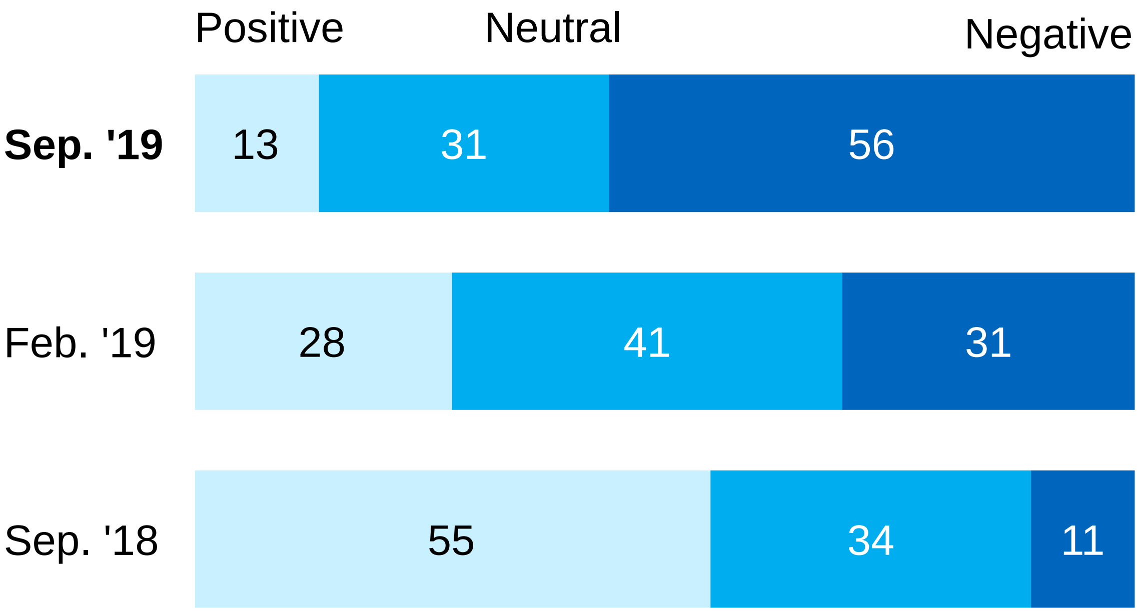
In a joint effort between CLEPA and McKinsey, we created an online-based survey to provide regular insights into current performance levels, trends, and overall industry sentiment

- Overall industry sentiment and outlook
- Reasons for the economic downturn
- Downturn reactions of automotive suppliers

Automotive industry – Only 13% of the respondents of the last Pulse Check Survey have a positive outlook for the automotive industry – and the majority thinks an economic downturn is coming

Percent of respondents

What is your general outlook for the automotive industry in total?



Selected quotes on recent decline in outlook

> At the **beginning of this year** I thought it were **just some little negative bubbles** because of Brexit, new CO2 standards, etc. - **But it's more!**

> Besides the **high investment needs,** there are mainly two topics: the **downtrend in China** where the OEMs have earned a lot of their profit and an **increasing global competition** as Chinese OEMs are close to be ready to go global

> The **situation in China is worsening**, so in terms of **revenues and profitability** it can **go down**

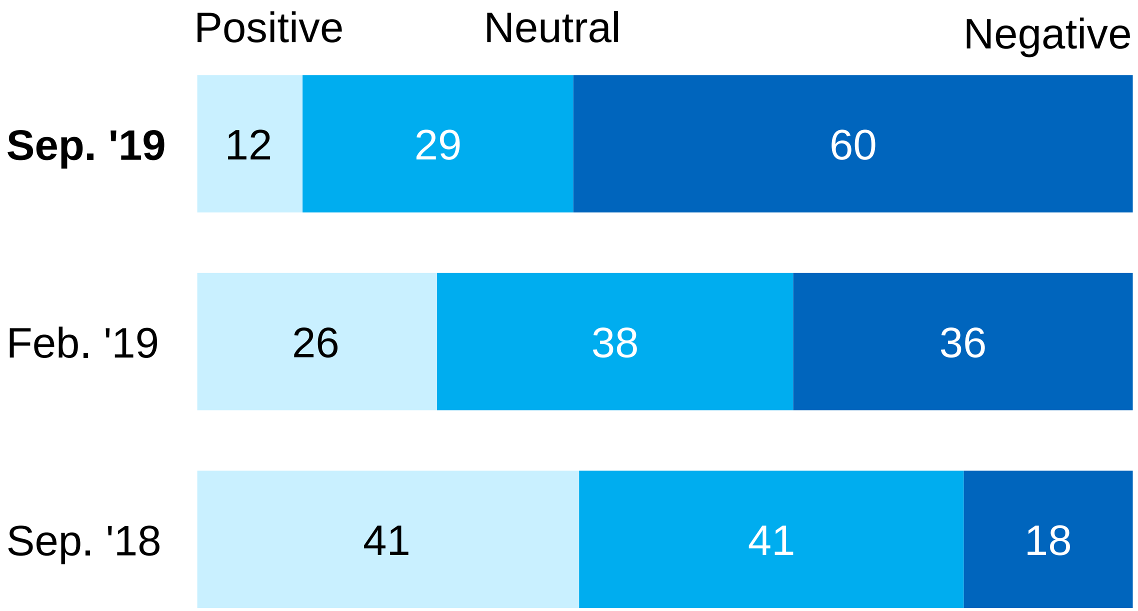
Note: Answer scale from 1-7; with answer options 5-7 interpreted as positive, 4 as neutral, and 1-3 as negative
N = 44 (Sep. 2018), N = 58 (Feb. 2019), N = 52 (Sep. 2019)

SOURCE: McKinsey CLEPA Pulse Check Survey

Supplier industry – Similarly, the outlook for the automotive supplier industry has decreased with specific problems being lower volumes, high investment needs, and the continuous OEM pressure

Percent of respondents

What is your general outlook for the supplier industry?



Selected quotes on recent decline in outlook

> **Increasing price pressure** on suppliers from both **raw material market** and **OEMs**

> During the past 6 months we have seen **several tier N+ suppliers** facing **financial difficulties** – too many of them have been unable to **finance the investments for new technologies**

> **Sales volumes contraction** on **ICE application** in particular for Diesel, but still **low volumes in electric**

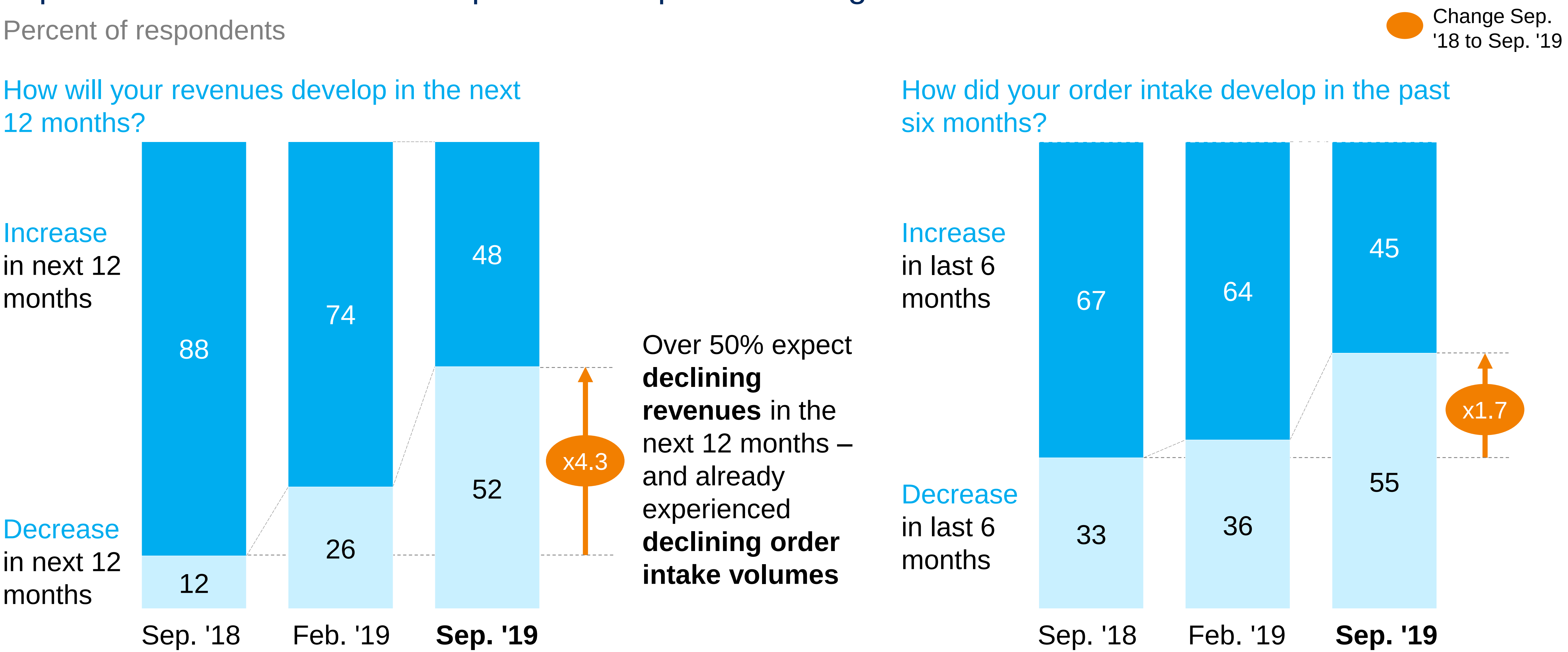
> **OEM call-offs** being **reduced**, booked business with **delayed SOPs** and **lower volume**

Note: Answer scale from 1-7; with answer options 5-7 interpreted as positive, 4 as neutral, and 1-3 as negative
N = 44 (Sep. 2018), N = 58 (Feb. 2019), N = 52 (Sep. 2019)

SOURCE: McKinsey CLEPA Pulse Check Survey

Revenue development – The negative outlook is also reflected in the short-term revenue expectations – over 50% of respondents expect declining revenues in the next 12 months

Percent of respondents



Note: Displayed percent values without accounting for "N/A" answers, N = 44 (Sep. 2018), N = 58 (Feb. 2019), N = 52 (Sep. 2019)

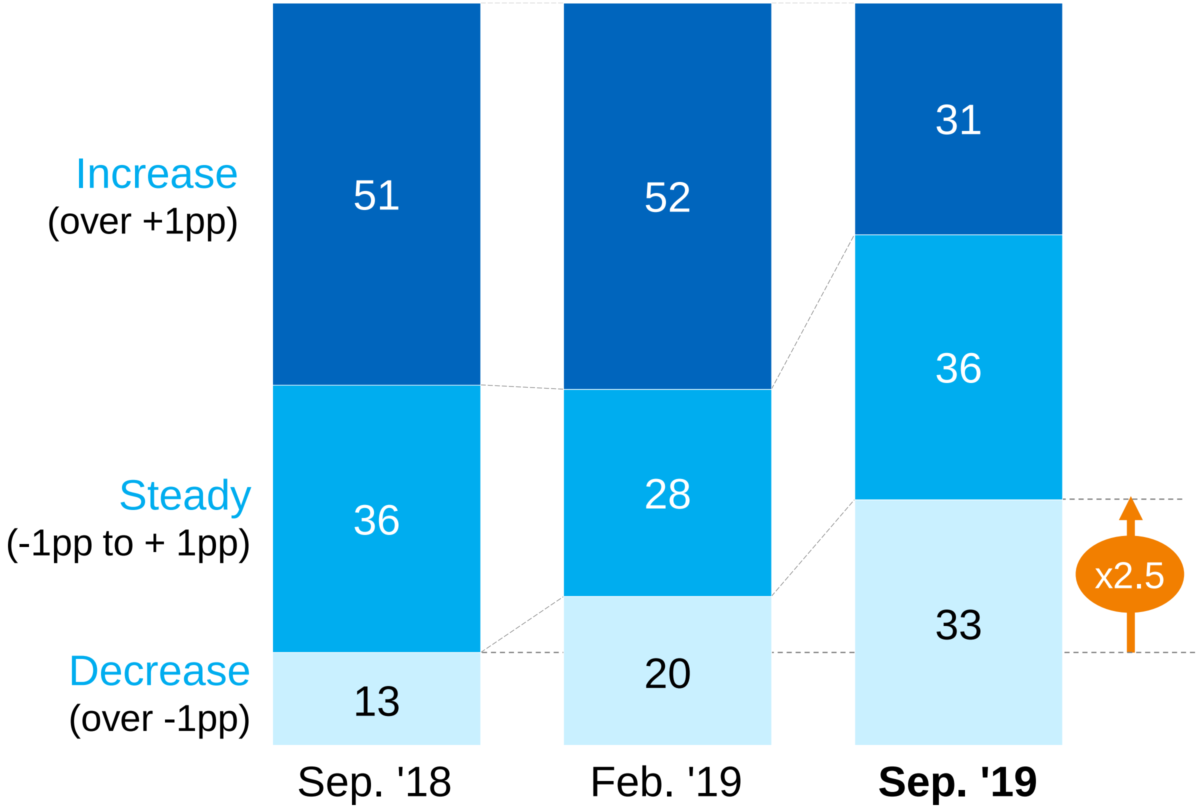
SOURCE: McKinsey CLEPA Pulse Check Survey, press research

Profit expectations – One third of the participating companies anticipate decreasing profits in the next year – an increase by 2.5x compared to last September

Percent of respondents

Change Sep. '18 to Sep. '19

How will your profitability (EBIT) develop in the next 12 months?



“ Profitability impacted by **heavy investments** required for **EVs** and **new mobility**

“ **Negative APAC for the first time ever**. EMEA and NAFTA hovering but not growing. South America down.

33% of respondents expect **decreasing profits** in the next 12 months – 2.5x more than in September 2018!

Note: Displayed percent values without accounting for "N/A" answers; N = 44 (Sep. 2018), N = 58 (Feb. 2019), N = 52 (Sep. 2019)

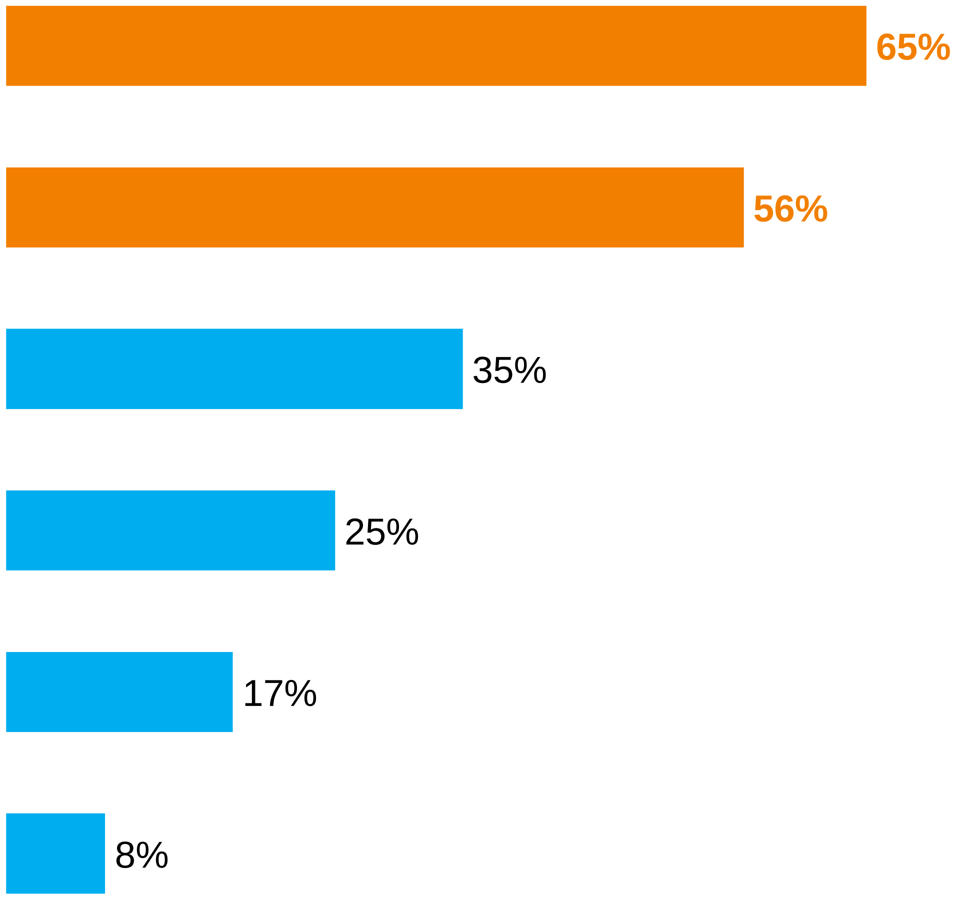
SOURCE: McKinsey CLEPA Pulse Check Survey

Downturn reasons – Out of the different headwinds driving the current industry downturn, trade wars and the changing demand in China are the greatest challenges for automotive suppliers

Headwind	Description
1 Trade war	▪ **Trade tariffs** between China and US, and also EU ▪ **Trade restrictions** and products/components (e.g., "Huawei-conflict")
2 Changing demand in China	▪ **Decreasing market demand** due to **falling consumer confidence** after slowdown of economic growth ▪ **Increase** in **tax rate** for small vehicles
3 Diesel crisis	▪ **Decrease in diesel sales** after manipulation of emission tests ▪ Ongoing **customer uncertainty** about potential driving restrictions
4 Brexit	▪ **Continuous unclarity** about **Brexit negotiations** and future **trade conditions** between EU and UK
5 Political instability and debt crisis	▪ **Uncertainty** about **impact** of **ongoing debt crisis** in certain countries (e.g., Argentina, Turkey, Italy) ▪ Increasing **instability of political landscape**
6 WLTP	▪ OEMs with **problems to obtain certifications** for **new WLTP standard;** sales push before introduction ▪ **New RDE regulations** (effective 09/2019) might trigger similar problems

Importance of headwind based on pulse check survey

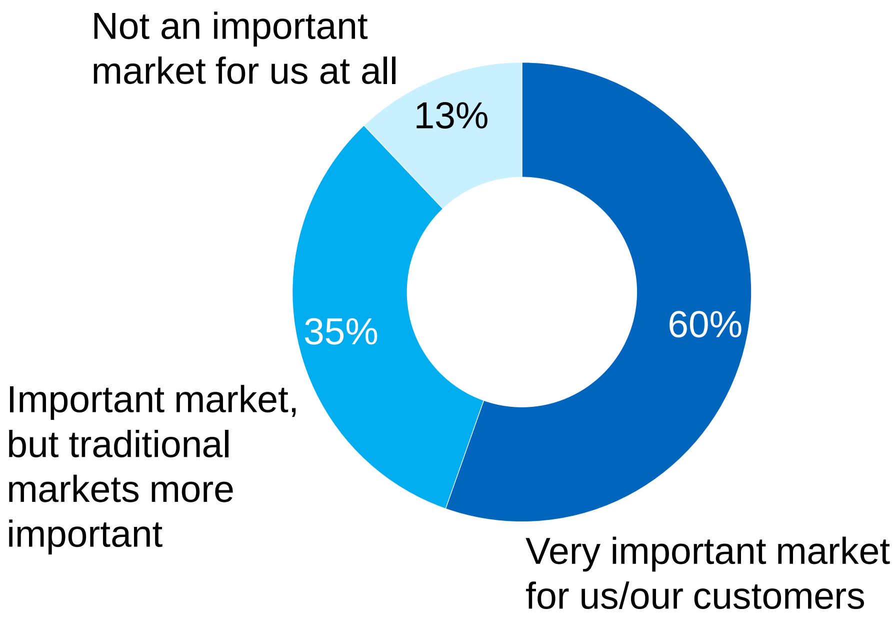
Top 3 reasons (N = 52)



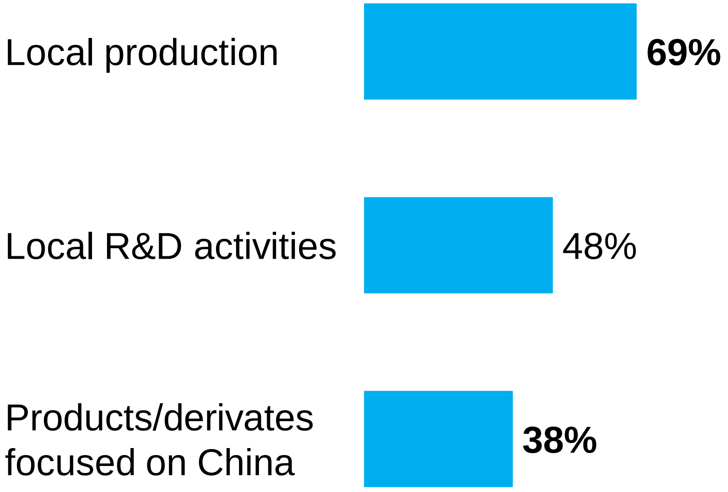
SOURCE: McKinsey CLEPA Pulse Check Survey; McKinsey analysis, press articles

China – China is a very important market to nearly all responding automotive suppliers – however the majority of suppliers is without local R&D and targeted products for the Chinese market

Which role does the Chinese market play for you? (multiple answers possible)



What activities do you currently perform to address the Chinese market? (select all that apply)



“ **China** is the **market for future growth**, this is why it is so critical for us

“ A **declining car sales in China** is a **downfall for us**

“ China is our biggest region, being the **reference market for most of our global customers**

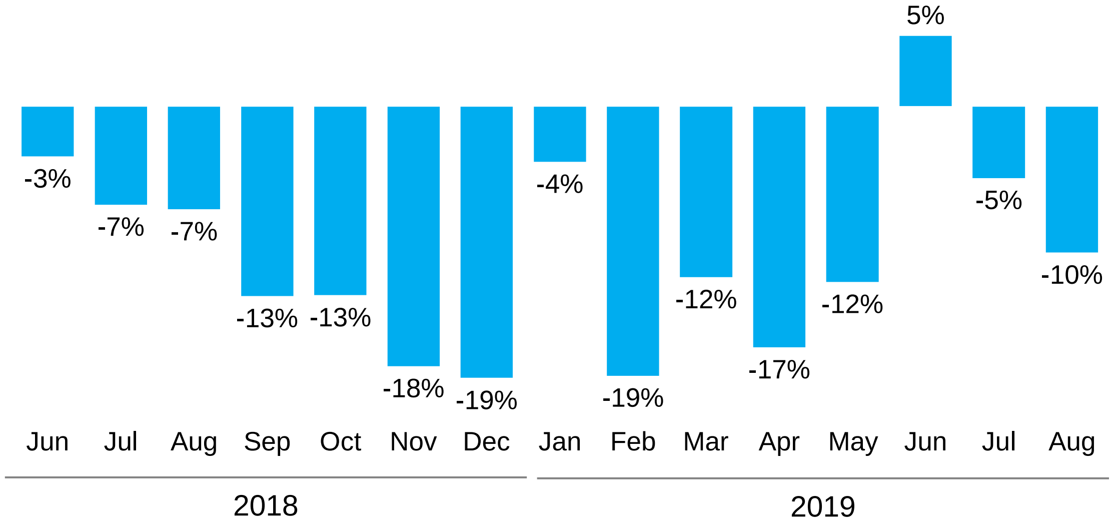
! While 69% of automotive suppliers already produce locally, only 38% offer specific products/derivates focused on the Chinese market

Note: Displayed percent values without accounting for "N/A" answers
N = 52 (Sep. 2019)

SOURCE: McKinsey CLEPA Pulse Check Survey

China – After years of strong growth, the development of the Chinese car market slowed down clearly due to a general economic slowdown, price increases and political regulations

China passenger car retail volume,
Change from same month previous year



- Monthly car sales in China **decreasing compared to last year** since June 2018
- **Exception in June 2019** due to promotion of China V cars as a result of China V/China VI emission policy change
- China **as most important market**, especially for premium OEMs, accounting for up to 30% of global sales volume

Main reasons

Increase in purchasing tax rate

- **Increased tax rate of 10%** for small vehicles[1], up from 5% (2016) and 7.5% (2017)
- **Triggered pre-sales in 2016/2017** and thus artificially increased sales figures in previous years

Economy slow down and stock market fall

- **Slowdown of GDP growth over recent years** – with only ~6.2% in Q2/2019, GDP with **smallest growth since early 1990s**
- **Stock market decrease** in 2018 (up to -24%) generated anxiety about potential downturn
- More **restrictive granting of credits**
- Corresponding **decrease in consumption power/confidence** on spending money

Market outlook

- **Market** expected to **grow again**, however at a **smaller growth rate**
- **Key drivers fueling future growth expectations**: overall low penetration rate, improved affordability, better infrastructure

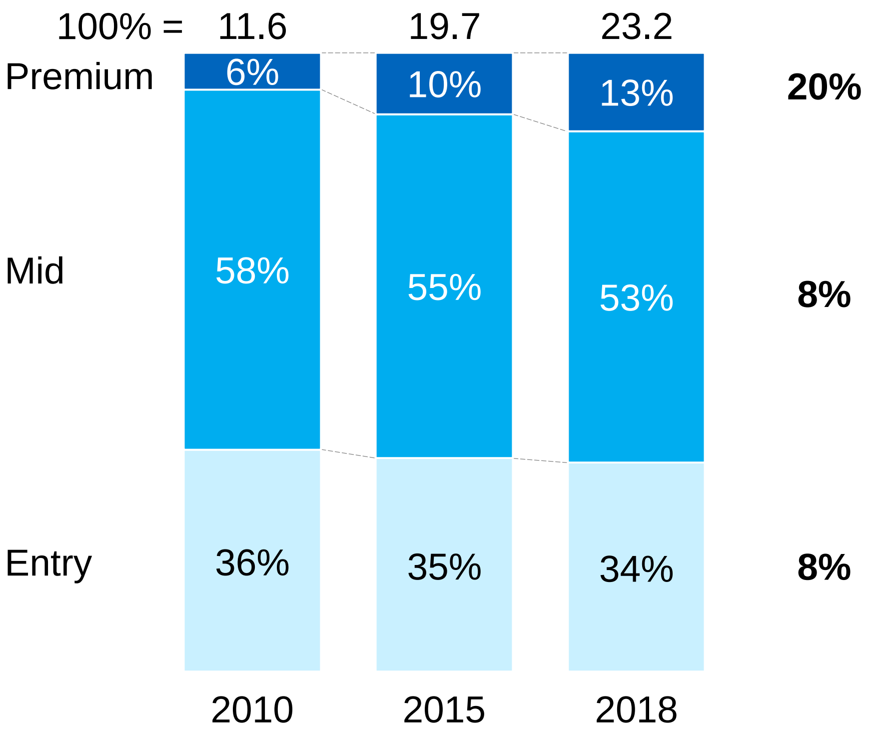
1 engine below 1.6l

SOURCE: McKinsey; press research; CPCA; China Automotive Industry Yearbook, National Bureau of Statistics

China – Continuing trend of mid-market squeeze and local competitors increase pressure especially on EU/US volume players – and thus also on their automotive suppliers

The mid-market in China is losing market share to the entry and premium segments

China passenger car sales by segments[1] **CAGR**
2010-18, Million 2010-18



Pressure from the top: More premium brands targeting the volume segment

	OEMs	Example model and start price
Global OEMs	BMW	BWM 1-series: ~ 200K RMB
	Audi	Audi A3: ~190K RMB
Local OEMs	LYNK & CO	LYNK 01: ~ 160K RMB
	WEY	WEY VV7: ~ 170K RMB

Pressure from the bottom: More competitive models emerging

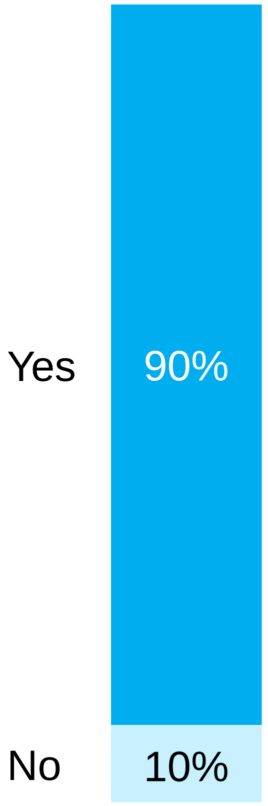
Global OEMs	JETTA	VW launches the **new JETTA Brand** to **target first time buyers in low-tier cities** and compete with budget segment local brands
Local OEMs		Baojun launches the **new SUV model RS-5 to compete with JV peers**, with a revised logo and super rich car specs, price ranging in RMB 116k to 146k

1. Price classification (rough): Premium: Avg. price > RMB 200k; Mid: 100k to 200k; Entry < 100k

Source: IHS Markit (Sep 2019); press search

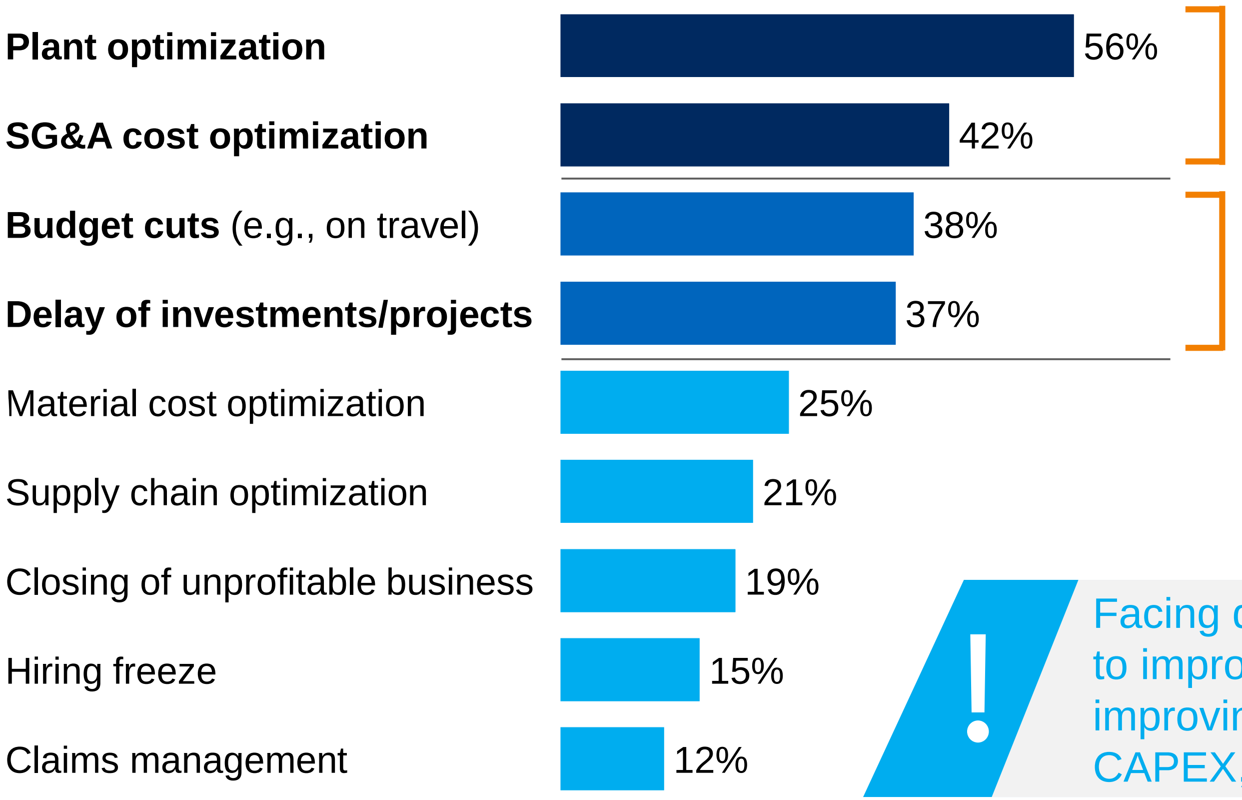
Reactions to the downturn – 90% of the respondents are undertaking specific measures to prepare for a downturn and focus both on improving the cost structure and short-term levers with bottom line impact

Do you take any specific measures to prepare for an industry downturn?



In which areas do you undertake measures to prepare for a downturn?

(select all that apply)



Mid-term measures to structurally **improve cost base**

Short-term levers to achieve **bottom-line impact**

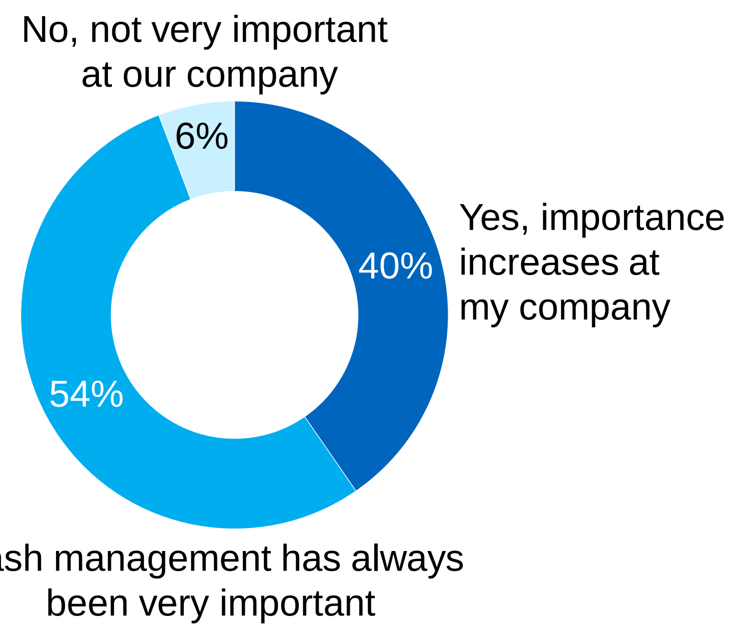
! Facing declining revenues, suppliers aim to improve their financial position by improving cash and liquidity, optimizing CAPEX, and saving operative costs

Note: N = 52 (Sep. 2019)

SOURCE: McKinsey CLEPA Pulse Check Survey

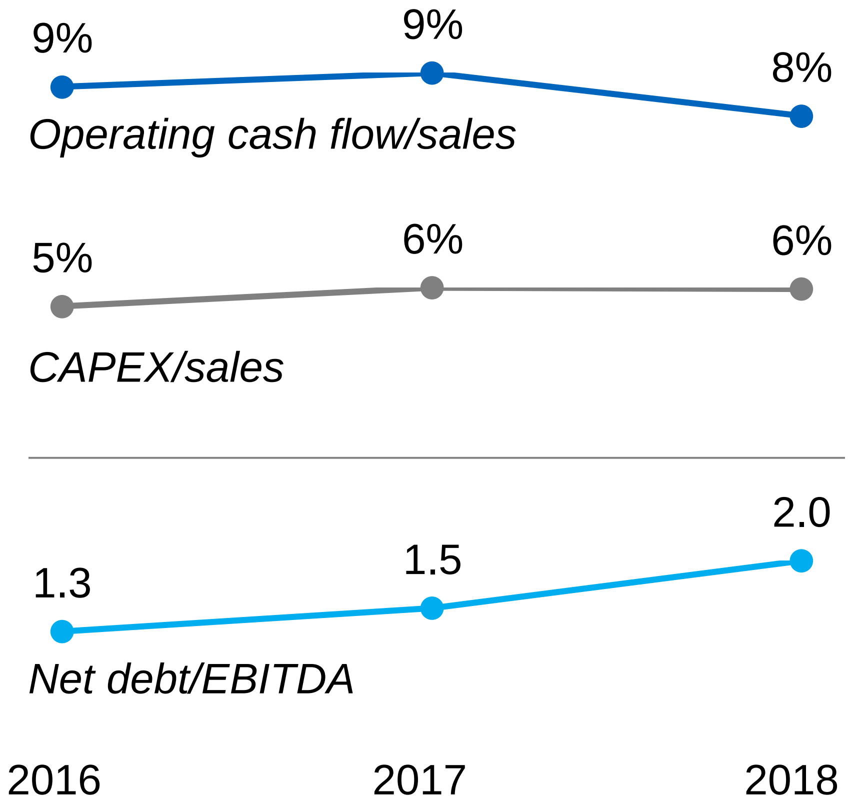
Cash management – Importance of cash management increased strongly due to the current challenges – which can also be observed when looking at key financial indicators of EU automotive suppliers

Do you observe an increasing importance of cash management with the current challenges?



Importance of cash management is increasing with OEM cost pressure and tougher competition

Development of financial indicators for EU auto suppliers[1]



First **decline** in **operating cash flow** while **investments remained stable** in 2018

- **Op. CF/sales:** Decreasing ratio as early warning indicator for potential cash problems
- **CAPEX/sales:** Indicates continuous investments over recent years

Net debt/EBITDA as typical **covenant in credit agreements** – recent increase **reduces leeway for management**

Note: N = 52 (Sep. 2019)

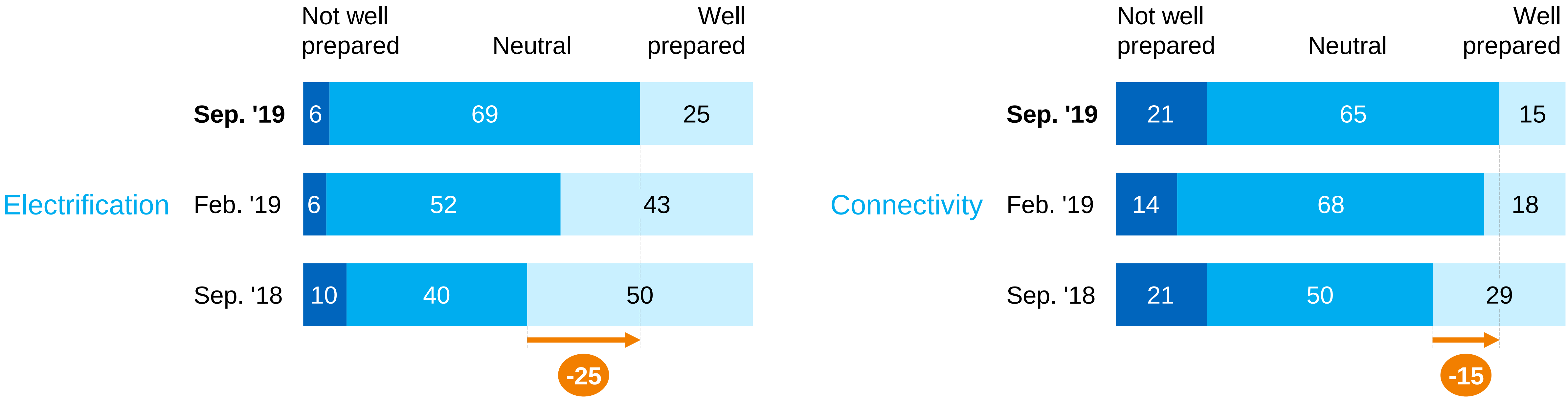
1 Analysis of financial indicators for largest 28 automotive suppliers with HQ in Europe

SOURCE: McKinsey analysis, Capital IQ

Trend readiness – Despite the short term focus on the economic downturn, its critical for automotive suppliers to not compromise on the development of future technologies – focus on EV, connectivity

Percent of respondents

How well prepared do you perceive your company to face these key trends?



! Perceived readiness for electrification and connectivity has clearly decreased over the last year – however automotive suppliers must build up capabilities in these future-oriented business areas and cope with the current economic downturn at the same time!

Note: Displayed percent values without accounting for "N/A" answers , Answer scale from 1-7; with answer options 6-7 interpreted as well prepared, 3-5 as neutral, and 1-2 as not well prepared
N = 44 (Sep. 2018), N = 58 (Feb. 2019), N = 52 (Sep. 2019)

SOURCE: McKinsey CLEPA Pulse Check Survey

Reactions to the downturn – We distilled the elements of top supplier performance transformations and identified 7 key patterns in target setting, approach, impact orientation, and strategic alignment

Key dimensions of successful performance transformations

1	Set clear targets	Clear **top-down targets** based on **benchmarks/full potential assessment** and rigorous **progress monitoring** supported by one common **digital tool**
2	Follow dual approach	Combination of **overarching** and **Divisions / BU-specific levers** with full accountability of relevant central functions and Divisions / BUs and carefully tailored central orchestration
3/4	Focus on sustainable impact and quick wins	Focus on **prioritized levers** with biggest impact to increase SPV, OPV and PPV **Quick wins** in parallel for immediate performance uplift
5	Embed in strategy	Embedding in **overall growth strategy** by cutting old ties and heritages, changing the way of working, and laying the groundwork for strategy journey
6	Manage performance	Measure-based **performance management and monitoring** (e.g., clear accountability, synchronized maturity levels, clear baseline, EBIT bridges)
7	Mobilize to execute	**Change story** and performance booster with **innovative measure generation,** incl. targeted best-practice transfer, capability building, change, and communication

Benchmark-based **full potential assessment** can be an important starting point for targeted transformation efforts

Source: McKinsey

The results of the third CLEPA pulse check depict an anxious industry which faces an economic downturn and political disturbances – while at the same time looking for the right solutions along the path towards the future of mobility.

SOURCE: McKinsey CLEPA Pulse Check Survey

Overall industry sentiment and outlook – Only 13% of respondents maintain a **positive outlook** for **the automotive industry**, the current industry sentiment is much more negative than in the previous pulse checks – and **98% of respondents expect an economic downturn.** Correspondingly, **revenue and profit forecasts** are **decreasing**, with 52% expecting decreasing revenues and 69% decreasing or stagnating profits over the next 12 months.

Reasons for the economic downturn – The two **main reasons** are primarily **trade wars** (esp. US-China) and the **negative market development in China** – other reasons include the reduction of Diesel sales and the upcoming Brexit. **China** depicts are **very important market** for nearly all automotive suppliers – however we observe **slowing growth in vehicle sales** and **increasing competition** also from local players.

Downturn reaction of automotive suppliers – 90% of respondents have already **launched specific measures** or programs in **reaction to the downturn.**

Applied levers: Automotive suppliers address the downturn with both **long-term measures** to **improve operative performance** (e.g., plant or SG&A optimization) and **short-term, bottom-line focused levers** (e.g., budget cuts, delay of investments), grounded in good understanding of full potential.

Cash management: Focus on cash management increased strongly (more important for 40% of respondents) – especially important to improve operating cash flow and to meet financial covenants.

Future trends: Despite the current focus on coping with the downturn, **automotive suppliers must not lose sight of future trends** – especially as we see a **decreasing readiness for EV and connectivity.**

Note: Survey conducted in September 2019