



# **Supplier-Carmaker Relationships and Networks: Challenges for Suppliers**

*Federal Reserve Bank of Chicago – Detroit Branch  
The Supplier Industry in Transition  
April 18, 2006*

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Original Equipment Suppliers Association



## Original Equipment Suppliers Association

- Formed in 1998, affiliated with MEMA
- Serves the N. American supplier community
- 386 members
  - Global automotive sales over \$300 billion
  - Complete supply chain, Tier 1– n
  - Suppliers of modules, systems, components, materials, engineering, tools, dies, molds
  - Represent 65% of NA OE Sales
- Operates 12 peer group councils, 470 executives
- Conducts 24 events/year, nearly 4,000 participants
- Addresses a number of industry issues
- Serves as a credible industry voice and positive change agent



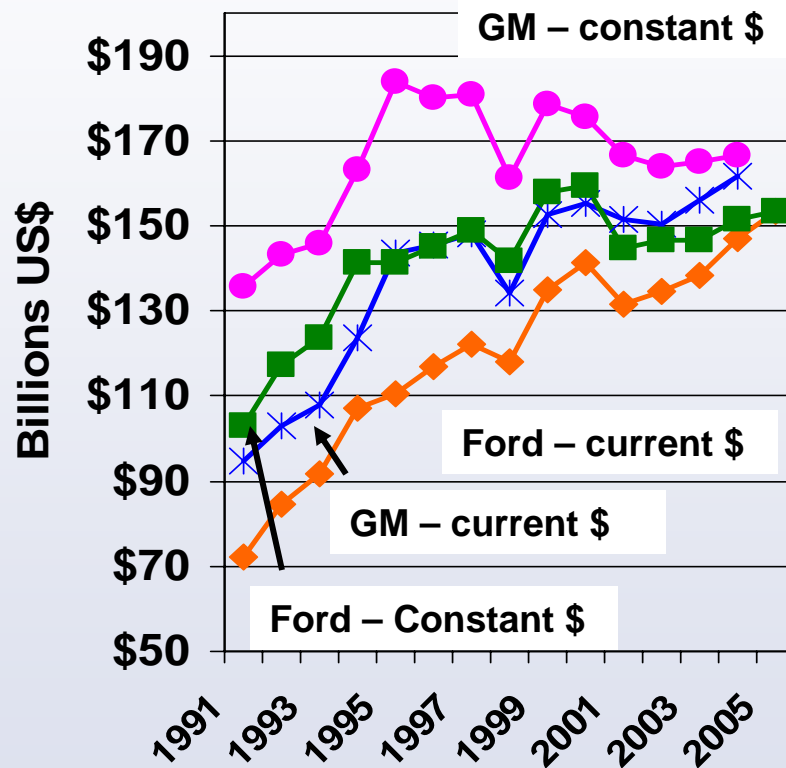
## Presentation Outline

- The Commercial Reality
- The Industry in Transition
- Supplier Relationships' Value Proposition
- The Relationship in Transition



# The Commercial Reality

Ford and GM real automotive revenues are flat



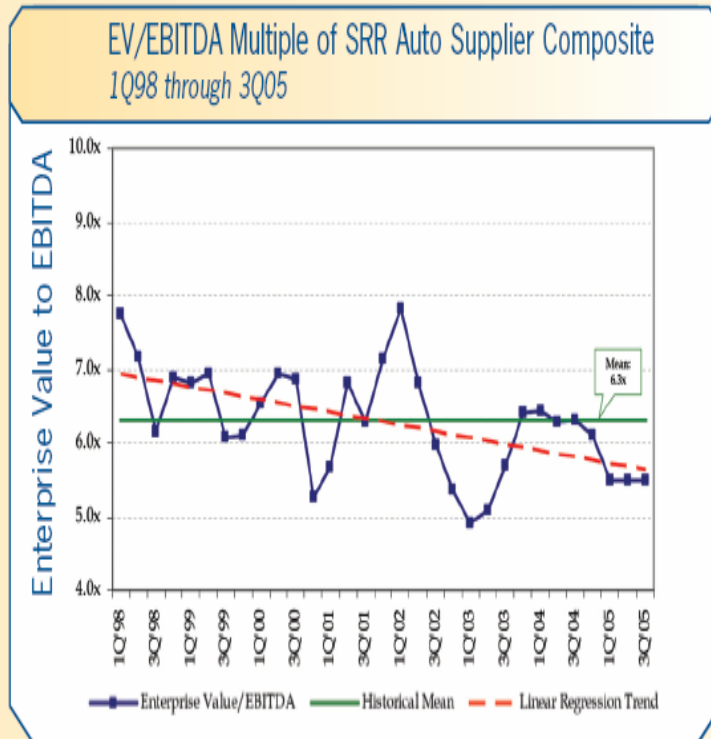
Note: constant \$ = 2005 dollars corrected by CPI

- It is perfectly rational with flat or declining real revenues that a company look to its largest cost component for relief
- In addition, raw material increases heavily influenced unfavorable cost positions at GM and Ford in 2004
- Short-term gains are the average 3 – 5% annual price reductions given by suppliers
- Two fundamental questions
  - Are cost (not price) structures truly changing in the industry?
  - Can the industry move to a new working model with a shared understanding of the attributes that characterize true collaboration?



# The Commercial Reality

Valuations and financials decay as margins are attacked



- Supplier valuations under pressure due to:
  - Inability to price
  - Supply base globalization
  - GM and Ford restructuring
  - Non-core assets divestitures
  - Surplus assets for sale
  - Delphi restructuring
  - Private equity and hedge fund interest
  - Changes in OE purchasing practices

Source: Stout Risius Ross



# The Commercial Reality

Oh, the Web We Weave . . .

## Normal Market Forces

- Steel prices rise (input costs up)
- Auto parts prices rise (steel up)
- Vehicle prices rise (materials up)
- Vehicle demand declines (increased cost to consumers)
- Steel prices reach equilibrium as demand declines creating excess capacity and competition
- Auto parts prices stabilize
- Vehicle prices stabilize
- Vehicle demand stabilizes
- Everyone shares in increased costs per market forces

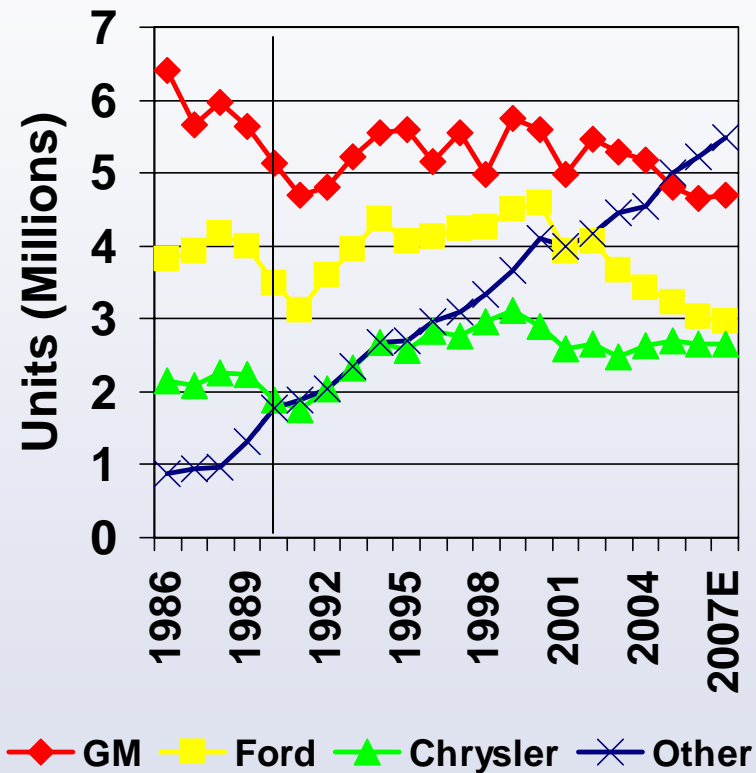
## Domestic Automotive Industry Forces

- Steel prices rise (input costs up)
- Auto parts prices stay same (no cost pass-through to OEMs)
- Vehicle prices stay the same (OEMs absorb their cost increases)
  - Labor cost is fixed (need to produce)
  - Incentives create artificial demand
- Vehicle demand stays high (consumers protected from steel price increases, and major incentives)
- Steel industry makes record profits on record volumes
- Auto parts suppliers have reduced margins and some go Chapter 11
- OEMs reduced margins due to higher costs/incentives
- Automotive OEMs and suppliers lose per their own behavior



# The Industry in Transition

Foreign Direct Investment Keeps Total NA Production Strong



- Chrysler Group rebounds from 1990; GM 500,000 units and Ford 400,000 units below 1990
- Restructuring announcements pull GM and Ford capacity equal to current run rates – can GM and Ford turn the trend?
- Foreign manufacturers forecast to increase to 5.5 million units of output in 2007 from 1.8 million in 1990
- Foreign manufacturers to control 35% of output in 2007
- NA supply base needs to diversify its customer base and exceed global competitive standards



## Industry in Transition

Structural changes abound – this is not a cyclical pattern

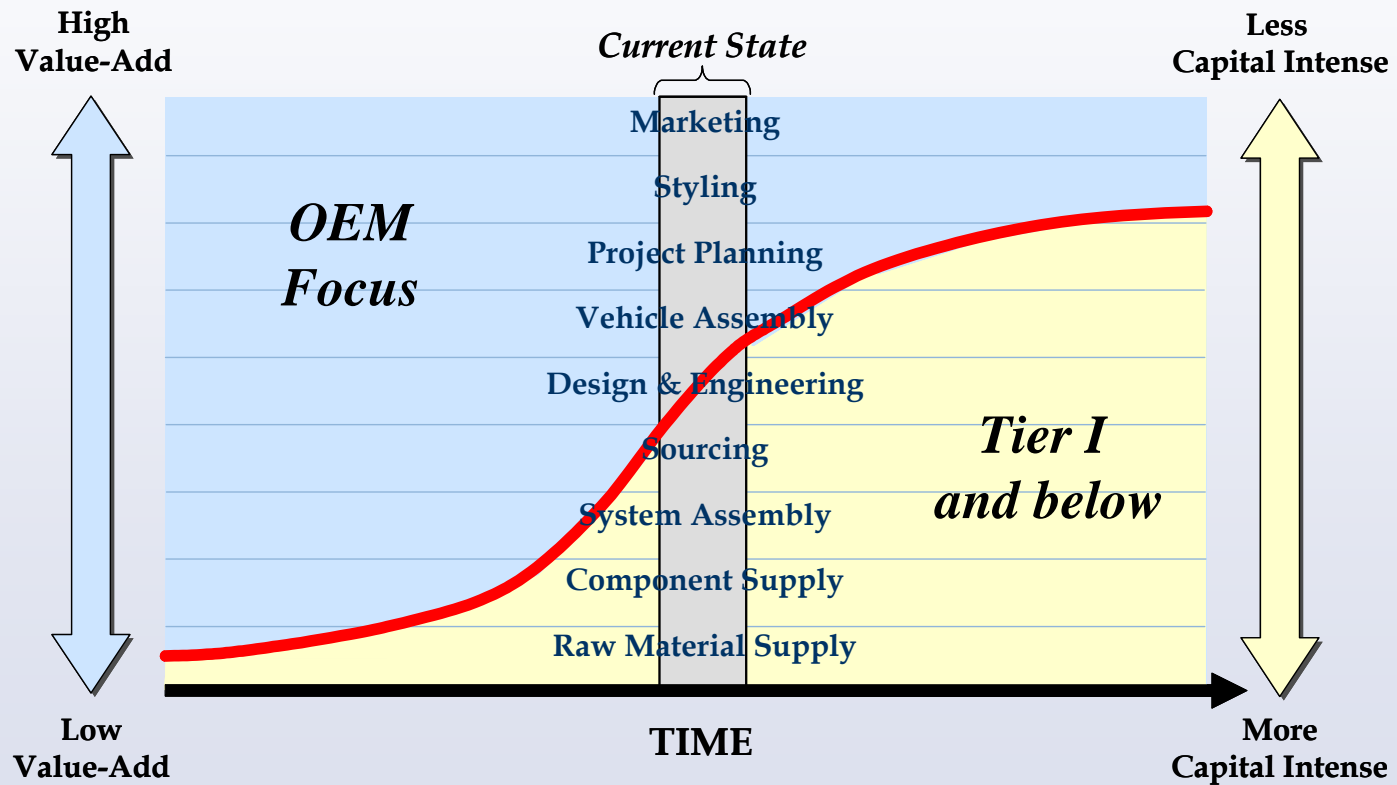
- GM, Ford, Chrysler Group with UAW open up contracts on active and retiree health care
- GM open to selling a controlling share of GMAC
- GM elects board member outside normal proxy
- Ford, GM, Chrysler Group initiate new supplier relationship programs
- Delphi & Dana – two, top ten firms – file Chapter 11 to restructure underperforming assets
- Ford takes back underperforming assets to restructure Visteon outside of Chapter 11



# Industry in Transition

Question: Who will create future value

## Shift in OEM Focus

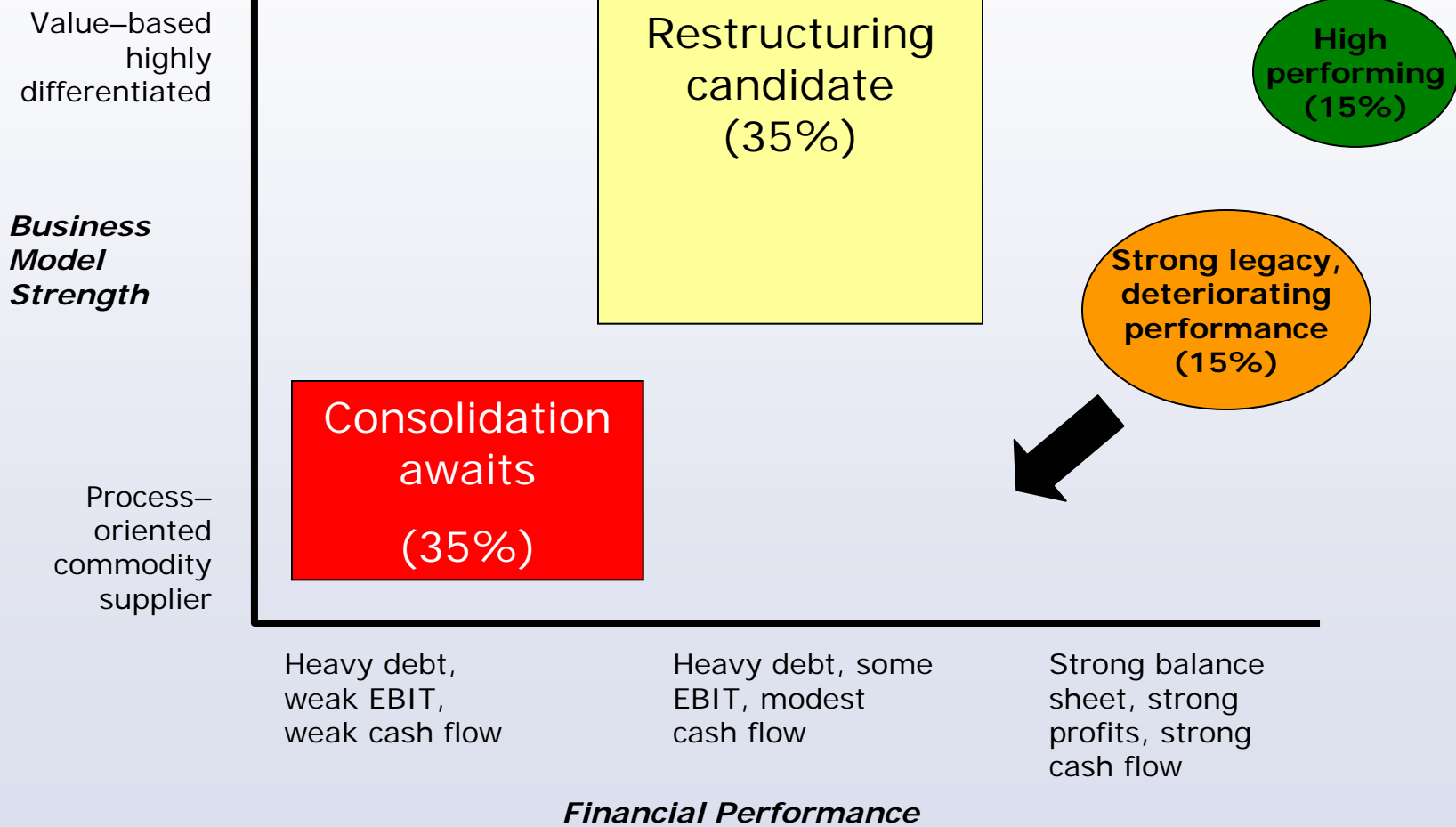


Source: Stout Risius Ross Advisors, LLC



# Industry in Transition

Question: Who owns future capital and profit streams



Source: Plante & Moran, PLLC proprietary data base, firm estimates



## Supplier Relations Value Proposition

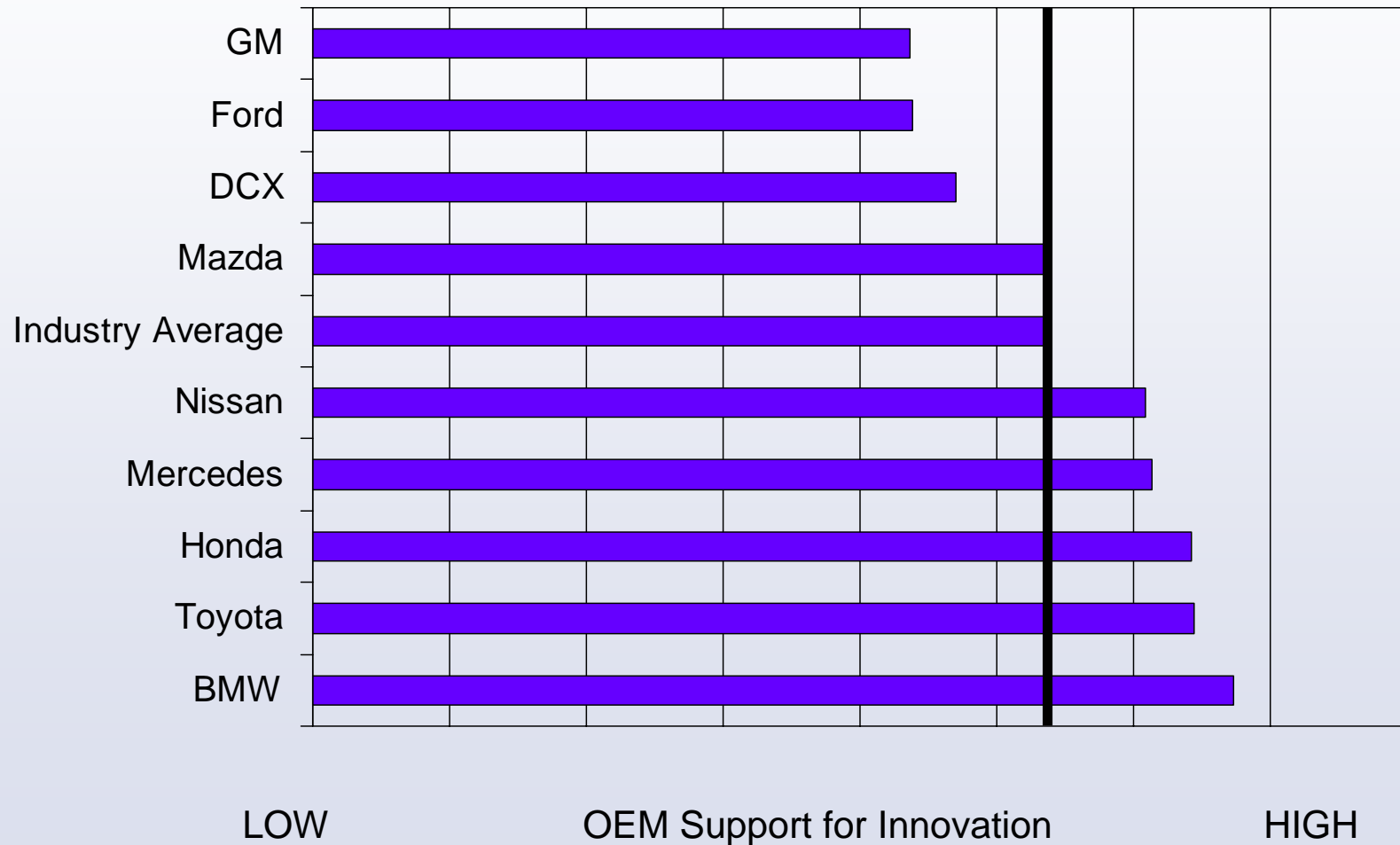
Hard dollar ROI is elusive; Intuitive ROI is a given

- Boston Consulting Group research points to an 8 to 10% one-time savings and a 3 to 5% annual savings to a “demanding, yet cooperative-trusting relationship.”
- Examples of these savings are developed in an Eastern Michigan University economics doctoral thesis and MIT International Motor Vehicle Program paper that shows positive correlation between strong working relationships and:
  - **Cost of goods sold performance** (1 percent improvement = 0.24% reduction in cogs/sales performance)
  - **Innovations per dollar of OEM R&D** (1 percentage = 0.6% reduction in R&D per new vehicle introduction)
  - **End product quality** (1 percent = 0.2% J. D. Power IQS improvement)
  - **Materials management** (1 point = 0.03 inventory turns improvement; GM automotive carries \$13.87 billion or \$33 million for each point)



# Overall OEM Innovation Support Rating

Intangibles of supplier relations appear in product development



Source: 2004 *Automotive News* and J. D. Power & Associates *News Pace Awards*



## The Relationship in Transition

McKinsey/OESA Survey: purchasing constrains progress

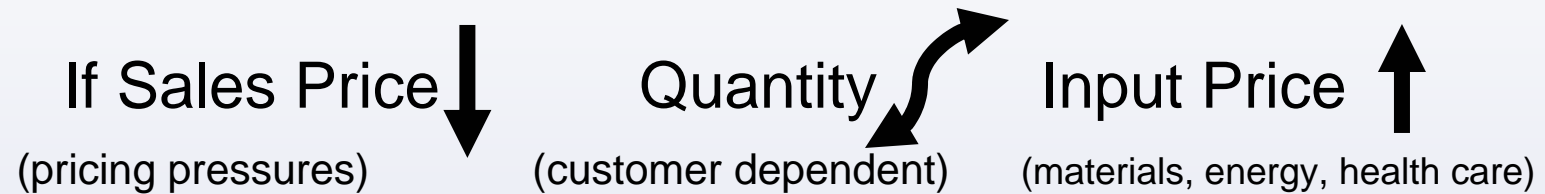
- Purchasing is viewed as a “backwater” function
- “Total cost” mindset is not prevalent (price focus)
- Tools and processes are not sophisticated or rigorous
- Indirect commodities do not receive significant focus
- Lip service is played to integrated global sourcing

Source: McKinsey/OESA February 2003



## The Relationship in Transition

With 2/3 of value – the supplier relationship is the link to savings



The only way to ↑ Margin is to

↑ Productivity

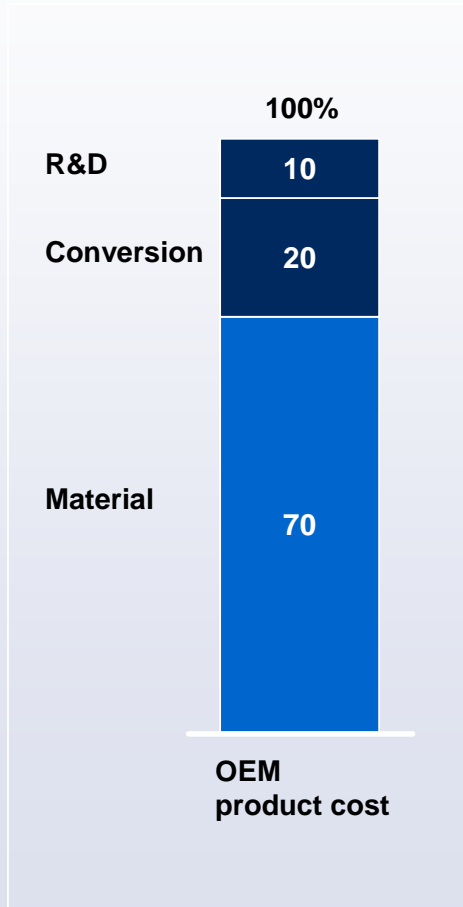
(product development, vehicle assembly value, supply chain management – most productivity improvement opportunities directly or indirectly involve the supply base)



# The Relationship in Transition

Significant waste is created by friction at the interface

High interdependence ...



... but significant interface waste created

Drivers of interface waste

Percent of total program cost, indexed\*



\* 100% = 5.2% of program cost

\*\* Straight average of all 43 programs

Source: OESA McKinsey Customer-Supplier Interface Study



# The Relationship in Transition

McKinsey/OESA Survey: pathway to success

- Target costs and fact-based purchasing are the basis of planning
- Global decisions are based on total landed costs and risks
- Partnerships are structured around performance expectations
- Supplier innovation is given greater emphasis
- Resources are allocated to strategic purchasing and outsourcing decisions versus tactical and firefighting activities

**A greater share of spend is transacted through  
a smaller number of key suppliers**

Source: McKinsey/OESA February 2003



## The Relationship in Transition

We can win together; or we can lose together

		Column Player	
		Cooperate	Defect
Row Player	Cooperate	(5, 5)	(-5, 10)
	Defect	(10, -5)	(-2, -2)

Source: Howard Raiffa, Negotiation Analysis



## The Relationship in Transition

A shared sense of collaboration requires a working trust

*Trust is fragile.* Once broken it is hard to restore. But at the same time, even though the players may not trust each other, each might be willing to maintain a cooperative pattern. They do this not because they empathize with each other, but because they trust that the other side will be wise enough to act in its own selfish interest by not rocking the boat. This is an important observation:

*Empathetic* trust is important, but not always indispensable in developing and maintaining a *working* trust.

Source: Howard Raiffa, Negotiation Analysis



## Conclusions

- **Perception is:** “GM and Ford are clueless as to how to work with their suppliers.”

James Womack, Wall Street Journal, February 13, 2006

- **Reality is:** Market situation of GM and Ford lead them to book hard cost savings today versus tomorrow’s uncertain relationship benefits. They know exactly what they’re doing.

- **Intuition is:** “We have a problem with the business model in this industry. It is not working effectively for our suppliers. It is not working effectively for us.”

Tony Brown, Ford Motor Company



## Conclusions

- **Opportunity is:** Customers and suppliers need to establish a working trust to reduce costs and risks inherent in automotive's commercial relationships
- **Realization will be when:**
  - Production shares stabilize
  - A cost-elimination mentality is institutionalized
  - Commercial leverage between customer and suppliers is equalized
  - Mutual dependency among all parties of the value chain is recognized and respected



*Thank you,*

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