

# **Prospects for Automotive Suppliers**

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The U.S. auto supply industry is in a shambles. The largest American company, Delphi, is bankrupt and so are Collins & Aikman, Tower and most recently Dana Corp. (Exhibit 1) Almost half of the fifty largest North American suppliers lost money last year and few of the others earned as much as 5% on sales.

Usually when an industry is doing so badly, the reason is weak demand for its products. But that is not the case with the automotive industry. Almost 17,000,000 cars and light trucks were sold last year, within 1% of the all time record.

As a newcomer to the industry it may be a bit presumptuous for me to be a prognosticator, but I believe that in 2006 there is significant risk that unit sales might go down by 2-4%, the Big Three might continue to lose share within the Big Six, and consumer preferences for small, less parts-intensive vehicles might intensify. If all three were to occur, the industry would experience a business environment as hostile as Hurricane Katrina.

What are the automotive meteorological factors that could create the perfect storm? The first is recent history. Consumers have been leveraging themselves up for several years with home equity mortgages, low to no interest cost car financing and multiple credit card usage. We don't know when the spending spree will lose its steam but by definition we are closer than ever before. In fact, consumers actually spent more than they earned during the past year. Our nation experienced dissavings for the first time since the Great Depression. During the last five years, household debt has grown twice as fast as household income, alarming such economists as former Federal Reserve Board Chairman Paul Volcker. There are some signs that the credit binge may be slowing down. On April 12, The Mortgage Bankers Association's index of applications for mortgages to buy a home or refinance an existing mortgage declined 5.5 percent. March saw a 1% decline and February a 6.3% drop. Mortgage refinancings are dropping even more sharply than new home mortgages, which means an enormous decline in incremental cash available for consumer durable purchases. In addition, consumers this year will experience cash pressures from rising interest rates on higher mortgage balances and from insurance, property tax, gasoline and home heating costs and electric bills. There also may be less of a wealth effect in 2006. When home values and stock prices rise, consumers feel more wealthy and are inclined to spend a portion of those unrealized gains. If, as seems likely, the housing price bubble is beginning to burst, there will be less wealth effect and perhaps even a negative one.

Second is the simple fact that so many cars have been sold recently, 50.4 million in the last three years and 74.4 million in the last five. Finally, the U.S. is a mature market in terms of per capita car ownership, with three cars for every four people of driving age. Therefore it is hard to believe that there is a shortage of relatively new cars or a lot of pent up demand. Instead, there is a strong argument that the rebates and discount financing simply accelerated buying decisions that otherwise would have occurred a year or two in the future. For how many years can you borrow from the future before it catches up to you? It would be a mistake to overemphasize one month, but it is true that March unit sales of autos and light trucks came in at a 16.5 million seasonally adjusted annual rate, down from the prior month 16.6 and the prior year's March SAAR of 16.8. Similar logic says that to the degree that Americans do buy cars they may buy smaller, less fuel and parts consumptive vehicles, including hybrids where the Japanese automakers have taken an early lead. Even last year, hybrids captured about 1% of the market.

The market share issue is more complex. It is heavily driven, of course, by consumer response to new models but also is affected by advertising, word of mouth and the number of dealerships. None of these factors augers well for the Big Three. Few believe that the Big Three's new models vastly overshadow those of their major Asian competitors, and the Asians' superior reputation for quality seems to be intact. In fact, this year for the first time ever all of the cars that were top rated by Consumer Reports were from Asian companies, and in a survey of automotive reporters, Honda ranked number one in both cars and trucks. As for advertising, sales growth of the foreign competition makes it easier for them to add to their budgets. As to dealers, the Big Three historically have had a larger number of better established dealers, but many of them have been hurt badly by recent trends and therefore are in a relatively weaker position than before. Therefore, there is a high probability that the Asians will continue to gain share, as they have done so far this year, at least for the next year or two. This would be a real problem for the American automotive suppliers because they tend to be over weighted with the domestic Big Three. Mark Fields, who has been charged with turning around Ford's North American operations, acknowledges that there is really no longer a Big Three. It is now the Big Six.

Small fluctuations in revenues cause much larger volatility in earnings because supplier margins are low and the margins on incremental revenues are several times as high as the overall ones. In any kind of manufacturing it is particularly difficult to reduce unit costs in an environment of shrinking unit volume. It is even more difficult in an environment of volatile raw material and energy costs, rising healthcare and pension costs, and contractual inflexibility in employment levels. Yet supplier contracts with OEM's usually call for annual price downs, in some cases as high as 3%.

The industry also is highly capital intensive because of tooling, development and other launch costs which at best are recovered over the life of the platform. It is a rare auto supplier whose capital expenditure needs do not exceed its depreciation. This capital intensity compounded by years of low returns on assets has created relatively highly leveraged balance sheets which in turn have limited companies' ability to diversify their geographic mix into the high growth automotive markets of developing nations. This conundrum will become increasingly difficult as the OEMs move their own production to China, India, Eastern Europe, Brazil, Mexico and other regions that have both low labor costs and the potential for rapid growth of domestic auto markets. Exhibit 2 shows that the United States and Germany are close to 100 times as saturated with automobile ownership as China and India. Japan is more than 75 times as saturated and even Thailand is about 7 times as saturated. When (Exhibit 3) you consider that China has four and one-half times as many people of driving age as the U.S. and that India has more than three times as many as we do, you can understand both the limited growth potential of the U.S., Germany and Japan, which together account for a majority of global automotive ownership, and the vast potential of the developing nations, especially China and India. If each of these two expanded to just one-half of Thailand's penetration, their automobile ownership would more than triple, from 12 million cars at present to 40 million. Yet, as you can see from Exhibit 4, India's auto production now is half that of South Korea's and China's is less than twice Korea's and less than one-third that of the U.S. As car production grows, so will the indigenous base of component suppliers. Interestingly (Exhibit 5), China, South Korea and India now import more than \$1 billion of parts annually from the U.S. because their own industries have not yet mastered all of the more complex components. But look at

Exhibit 6, which shows that U.S. imports of parts from those countries have more than tripled since 2001 to \$5.3 billion last year, but are still less than 3% of the U.S. auto supply market. Does anyone believe that they will remain at that low level? Overall parts imports (Exhibit 7) are some \$68.6 billion, or about one-third of the total auto part consumption, but this total is heavily skewed by the re-importations of assemblies from components initially exported to our NAFTA partners, Canada and Mexico, which account for 53% of total parts imports. This double counting helps to explain why our parts exports are more than half the amount of imports, but you will note that the U.S. has gone from being a slight net exporter in 1997 to its ever growing position as a net importer, now almost \$30 billion. Net importation of parts has quadrupled since 2001. Even more important than being a net importer of parts as parts, we have become an enormous net importer of parts in the form of finished vehicles. Exhibit 8 shows that we imported about \$145 billion of vehicles last year, an all time high and four times our exports.

As foreign automotive OEM's increasingly penetrate the U.S. market, they also establish assembly plants here but generally continue to favor their traditional home country suppliers, either by importing from them or by encouraging them to establish plants here. Many of those new facilities are in lower wage, right to work Southern states. The traditional U.S. suppliers tend to be located in the Midwest and the Northeast and to be unionized. They therefore are at both wage and transportation cost disadvantages relative to supplying the transplants' assembly plants. Consequently they are really battling two kinds of imports, one truly international and the other foreign-owned suppliers located elsewhere in the U.S.

At this point you may be wondering why I am so eager to invest in an industry with such a bleak near-term outlook. There are several reasons. First, auto supply is a huge industry, around \$200 billion domestically and close to \$500 billion globally. Individual companies may come and go, but the industry as such is here to stay.

The global industry is highly fragmented. At present, only Bosch has more than a five percent global market share. Delphi had been close, but as it divests operations and closes factories, its share is shrinking. The top five companies only have about a 22% combined market share and the top ten 36%. Inevitably, the present turmoil will lead to consolidation and elimination of much of the higher cost capacity and will reduce the present idle capacity, as much as 40% in some sectors. I believe that globalization is the most powerful present economic phenomenon and that it inevitably will lead to consolidation in most sectors of manufacturing, not just automotive.

Much of the initial auto supply consolidation will be bankruptcy-related since this is unfortunately the most efficient way to fix problems of cost structure and balance sheet. As large individual companies do restructure in this way, their resultant lower cost structure will put even more pressure on the ones that are teetering on the brink. Auto supplier bankruptcies are an economic application of Darwinian theories. Only the fittest will survive long term.

I believe that the rash of major bankruptcies ultimately will result in a revision of the supplier business model. The present high fixed cost structure encourages many struggling vendors to price based on forecast marginal costs of production and to absorb enormous commodity price risks. Some desperate companies actually seem to have taken business at less than marginal cost in order to break into a new customer. They theorize that once they become a supplier by means of a losing contract they will overcharge on some later contract and make it

up. Only the later contract never comes in at an exaggerated price. Companies that are stronger are less likely to indulge in such suicidal tactics.

Not only is the present supplier business model broken from the point of view of the suppliers. It also is broken from the point of view of the OEMs. The OEMs have learned from the recent bankruptcies that they are extremely dependent upon the continued solvency of their vendors. If any of the Tier 1 suppliers shut down, there would be severe disruption of the OEM's own production schedules. This is why they have had to commit hundreds of millions of dollars to C&A and others in their bankruptcies. It is also likely that by putting suppliers to the wall, or even through the wall, that the American OEMs have inadvertently created quality problems for themselves. A desperate supplier might be tempted to cut corners, for example, using a higher ratio of recycled plastic to virgin material just to stay alive. In the future, the financial condition of vendors will play a more important role in vendor selection, and as the geography of the OEMs becomes ever more complex, so will logistical issues of supply chain management. To deal with vast numbers of different vendors in each of an ever increasing number of countries simply cannot be the right long-term supply chain profile. If a car has 2000 parts and an OEM has ten different models in each of ten different countries, that is a universe of potentially 200,000 vendors. Instead, I visualize gradual movement toward the general direction of global platforms and global platforms will necessitate suppliers who can provide consistent design and quality in all important locales. This too can be best accomplished by large, well-capitalized suppliers. Major international corporations also will be able to provide enhanced research, design and engineering to the OEMs by amortizing those costs over a much bigger revenue base and by performing some of these functions in lower cost countries. If the right constituent businesses are pulled together, the suppliers also will approach more closely a customer mix that approximates the market shares of the OEMs. This in turn will ameliorate the current vulnerability many suppliers, especially smaller ones, have to individual customer market share swings over which they have little or no control.

Major global auto suppliers will not just locate factories strategically. They also will locate their engineers more logically. I was in India three weeks ago, partly because WL Ross & Co. had made a distressed investing joint venture there and partly to meet with the key players in the Indian automotive industry. A number of the factories were impressive, but what intrigued me the most was not the arbitrage between blue collar wages here versus there but rather the arbitrage in engineers' compensation. A good engineer in India makes a maximum of \$10,000 per year and a PhD. perhaps \$12,000. That means you could quadruple a developed country's engineering staff manpower and yet lower your engineering budget by moving the engineering function to India. And this situation seems likely to be permanent. Do you know how many engineers graduate each year in the U.S.? About 60,000. In India 240,000 and in China 200,000. Is it conceivable that our engineering graduates will be three or four times as good as the Indians and the Chinese? If not, how will we retain a technological edge in automobiles – or for that matter in any industry? I am of course aware that Toyota recently decided to open a research center here in Michigan and that is a great achievement for Governor Granholm, but I do not think it changes the overall arithmetic. Very few American auto suppliers have the combination of capital and experience operating in the developing world to develop and execute the kinds of global strategies that will soon become mandatory. We believe that we do. Anecdotally, this last trip was my 57<sup>th</sup> to Asia and in about 10 days I will be on my 58<sup>th</sup>. This next trip will be to China where we have been invited by a major OEM to interview jointly with them potential local partners for us to serve their needs in that locale. I am so convinced about

the future of China and India that my wife is threatening to wear saris and dress me in either Nehru or Mao jackets.

You have heard our analysis of the industry and our vision for its future, so it might be useful to outline how WL Ross & Co. has begun to implement these ideas. Last summer, we acquired shares of Oxford Automotive, a producer of stampings and mechanism in Europe, which had just emerged from a second bankruptcy, a so-called Chapter 22. It still had a lot of debt so we underwrote a \$100 million rights offering to clean up the balance sheet and we then began negotiation the friendly reverse takeover of a similar London Stock Exchange listed company called Wagon. That transaction has now been completed and the merged company has €1.2 billion of revenues, roughly a 10% market share of its products in Europe. In January, we established International Automotive Component Group, which acquired most of Collins & Aikman's Europe plastic interiors business. I say most of it because we did not take the Austrian and Italian operations and we consolidated facilities in the U.K. and Germany, renegotiated some wildly uneconomical contracts, cut out about 25% of SGA, accelerated an in-house recycling program, eliminated all indebtedness and terminated disadvantageous leases. It now is on target for achieving substantial profitability, has dozens of factory cost cutting initiatives underway, has a new head of engineering and is actively quoting new business both in Western Europe and for its under-utilized facilities in Czech Republic and Slovakia. Recently, we announced agreement in principal to acquire Lear Corp.'s European Interior Plastics business on a debt-free basis by issuing 34% of the stock in the merged European company which will have about \$1.3 billion in revenues and will both broaden our product lines and reinforce each company's market share of individual products. Lear is weak in products where C&A is strong and C&A is weak in products where Lear is strong, so the transaction is very complementary.

We also acquired last Wednesday from Collins & Aikman their 56.5% equity ownership of Plascar Ltda, as well as \$48.2 million of loans due from Plascar. Plascar is a \$200 million revenue company listed on the Sao Paolo Stock Exchange and is the leading automotive plastics company in Brazil, serving Daimler Chrysler, Fiat, Ford, General Motors, Scania, Toyota and Volkswagen.

Earlier, we acquired 77.7% of Safety Components International, a \$200+ million company that is the leading independent producer of airbag fabrics and airbag cushions. It is essentially debt free and for a small company has a very good map that includes Eastern Europe, Mexico, South Africa and a joint venture in China. It also has developed and is in the early stages of marketing a proprietary fabric called WeatherMax, which we believe will be a strong competitor to Sunbrella for awnings, umbrellas and outdoor furniture. We are working hard to find synergistic transactions for Safety Components.

We also continue to own Nikko Electric and Ohizumi, two Japanese auto suppliers which we acquired several years ago and which have successfully migrated much of their production to China.

As has been all too repeatedly reported in the media, we have a framework agreement with Lear Corp. regarding all of their interior plastics business and are competing to acquire Collins & Aikman's U.S. business and are looking at the other distressed suppliers in the U.S. You will note that our initial forays had been mainly outside the U.S. and this was quite deliberate. Earlier this year, the U.S. candidates for acquisition were virtually all forecasting

improved results this year, while we were forecasting, as we are now, the perfect storm. Now everyone in Motown has windshield wipers, headlights and seatbelts on so we are beginning to share the same weather forecasts. But, depending on how Delphi plays out, it may still be a bit early in the climate cycle.

I now would be happy to take a few questions but I am told that at these Federal Reserve Board events it is traditional that only softball questions are asked. Please honor that tradition.