



State of the US Auto Industry – The Supply Base Perspective

**2006 Automotive Outlook Symposium
Federal Reserve Bank of Chicago**

June 2, 2006

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Vice President
Original Equipment Suppliers Association



Original Equipment Suppliers Association

- Formed in 1998, affiliated with MEMA
- Serves the N. American supplier community
- 392 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, 500 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 –

Will the industry earn an honest return on capital?



- **The Set Up** – *the current situation*
- **The Hook** – *the industry's economic significance*
- **The Tale** – *the industry's new epicenter is China*
- **The Shut Out** – *the changes that make the US viable*
- **The Sting** – *the industry that will emerge*



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The Tale of *Two Economies and Industries*

2006 National Economy*

- GDP: **3.5%**
- Inflation: **2.3%**
- Employment growth: **1.6%**
- Compensation growth: **4.4%**

2006 US Automotive Industry

- Production units: **- 3.7%**
- CPI/PPI: **negative**
- Employment growth: **- 2.8% +**
- Revenue: **+ 3%**

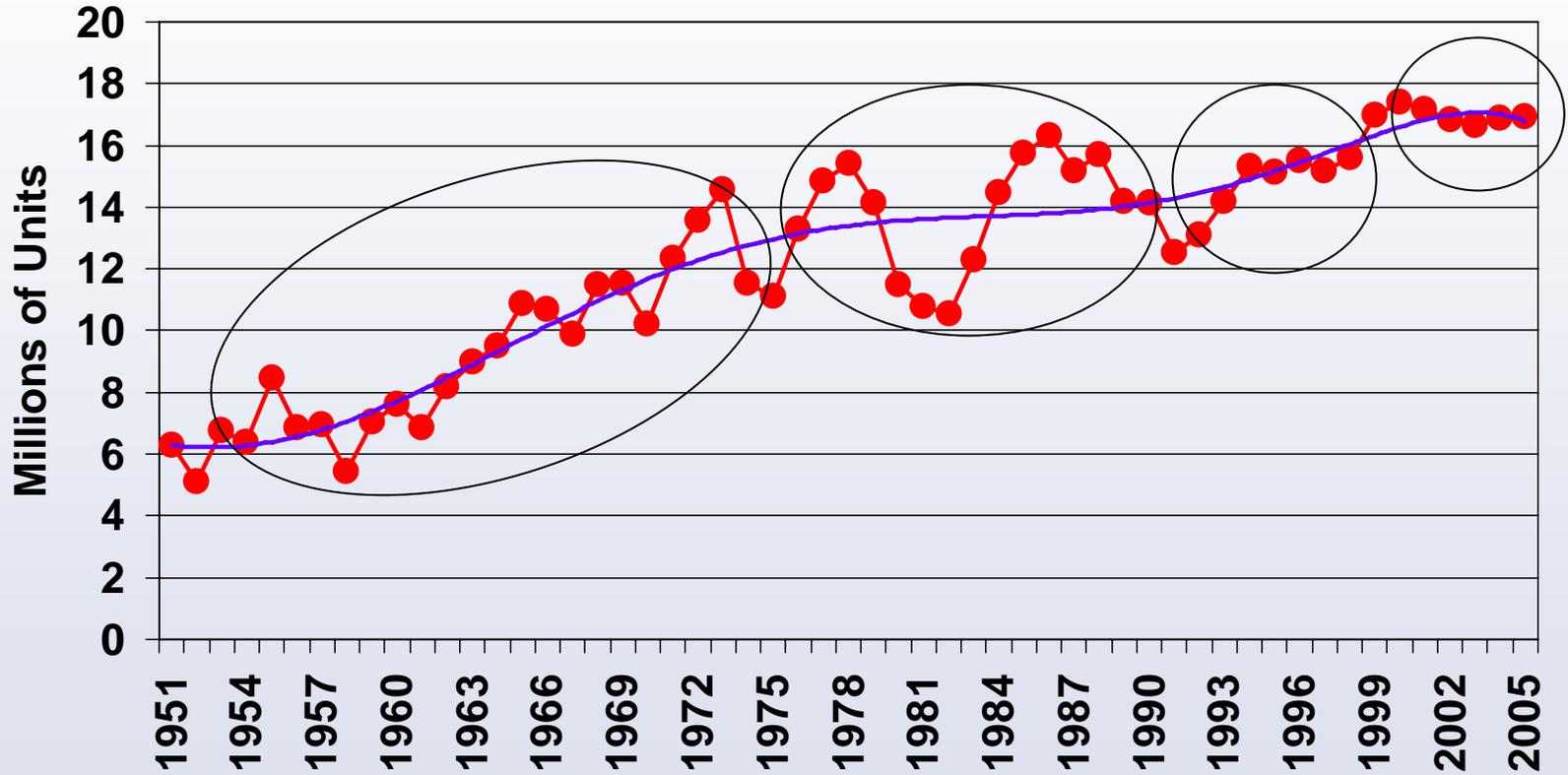
➤ Industry: 30% of the industry is performing very well and 30 to 40% under breakeven

*NABE May 2006 Survey



US Motor Vehicle Sales – Strong, but Flat

Company growth only at another company's expense

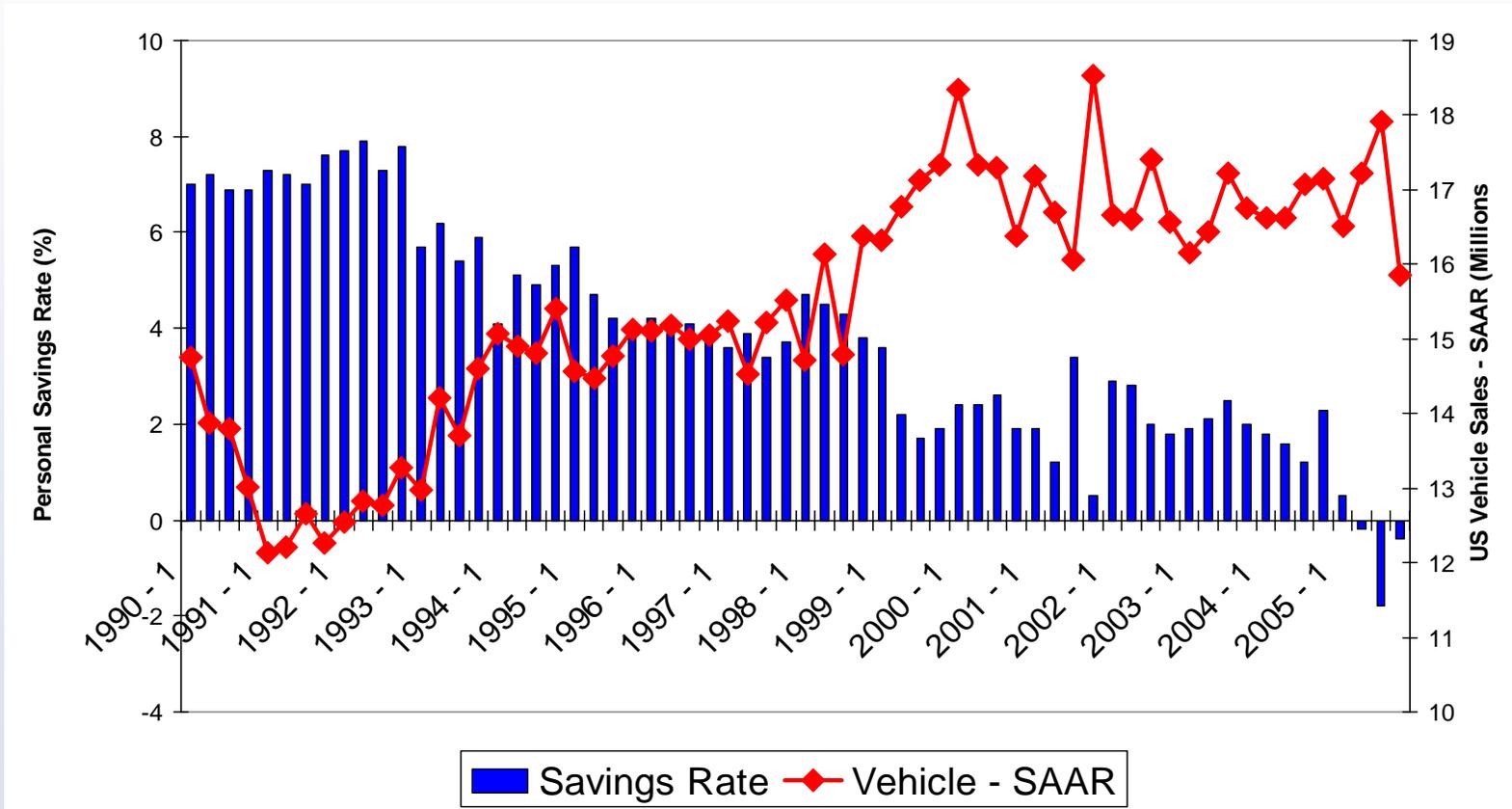


Source: Center for Automotive Research and McDonald Investments



Personal Savings Rate v. Vehicle Sales

With corporate benefits frozen – personal savings will increase

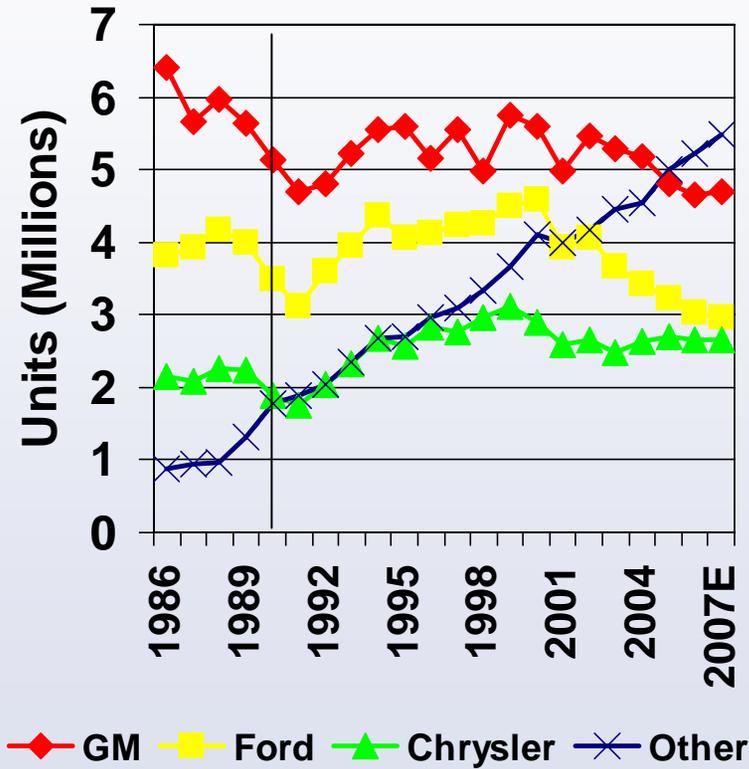


Source: Federal Reserve Bank of St. Louis



The Industry in Transition

Foreign direct investment keeps total NA production strong



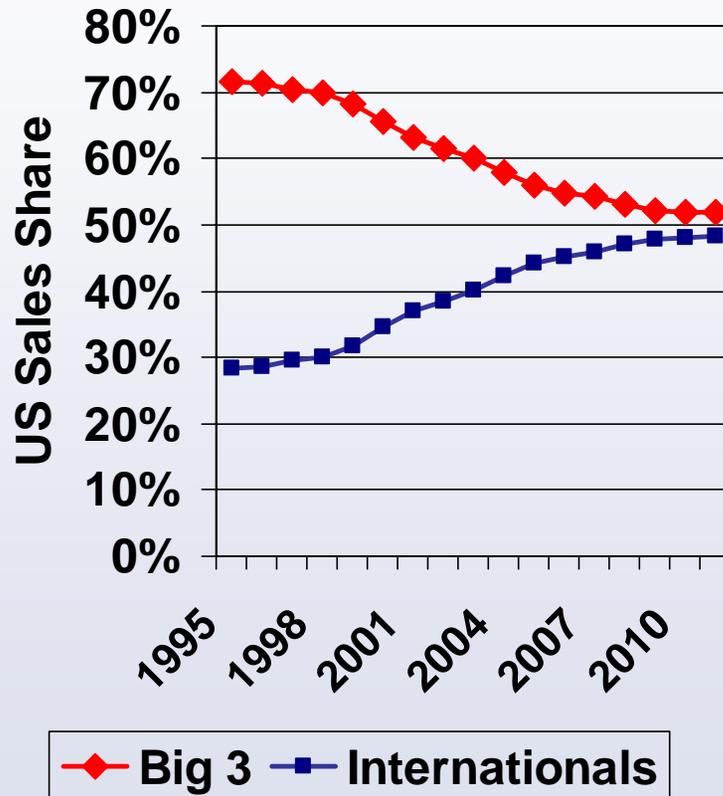
- Chrysler Group rebounds from 1990; GM 500,000 units and Ford 400,000 units below 1990
- Restructuring announcements pull GM and Ford capacity equal to current run rates – can GM and Ford turn the trend?
- Foreign manufacturers forecast to increase to 5.5 million units of output in 2007 from 1.8 million 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

Source: KeyBanc Capital Markets



Ford, GM, DCX Sales Shares Decline

Current round of cuts increases utilization to target rates



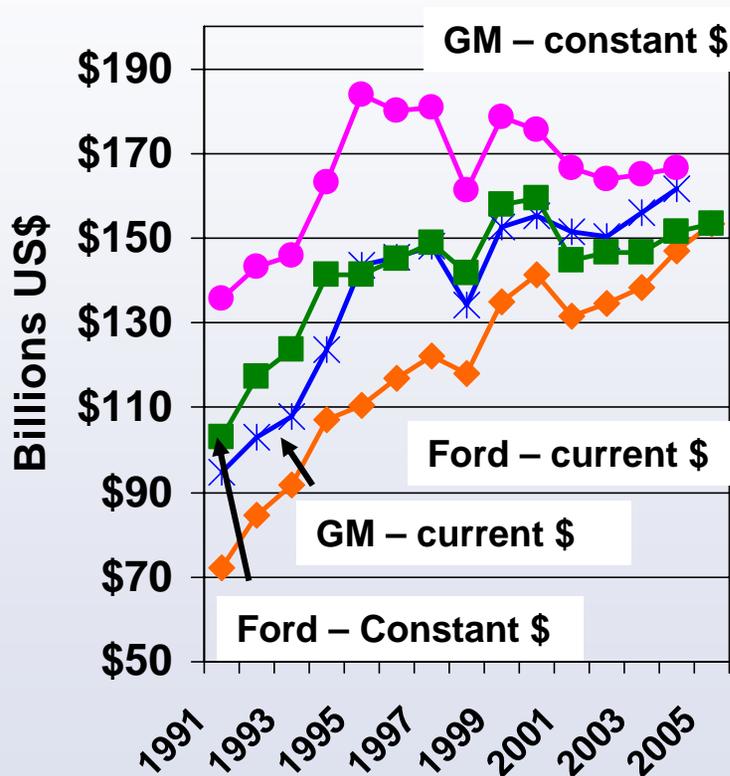
- Ford and GM forecasted to continue to lose 1 to 2 market share points per year through 2008
- Greatest risk post-2008: will the market share declines stop?
- Optimistic: Ford, GM, DCX share level off at 50 to 52% in 2008-2010 from 56% in 2005
- Other forecasts: share could fall to 48 to 50% - an additional 3 assembly plants

Source: Center for Automotive Research



The Commercial Reality

Ford and GM real automotive revenues are flat



- 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 2004/2005
- 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?

Note: constant \$ = 2005 dollars corrected by CPI

Sources: Company reports



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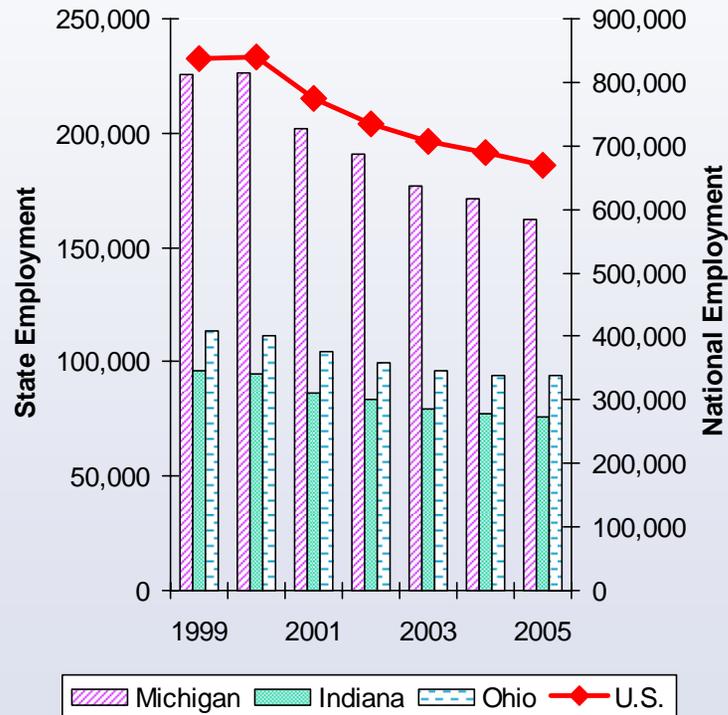
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Industry Employment Remains Significant

Threshold will be determined within next decade

Motor Vehicle Parts Employment



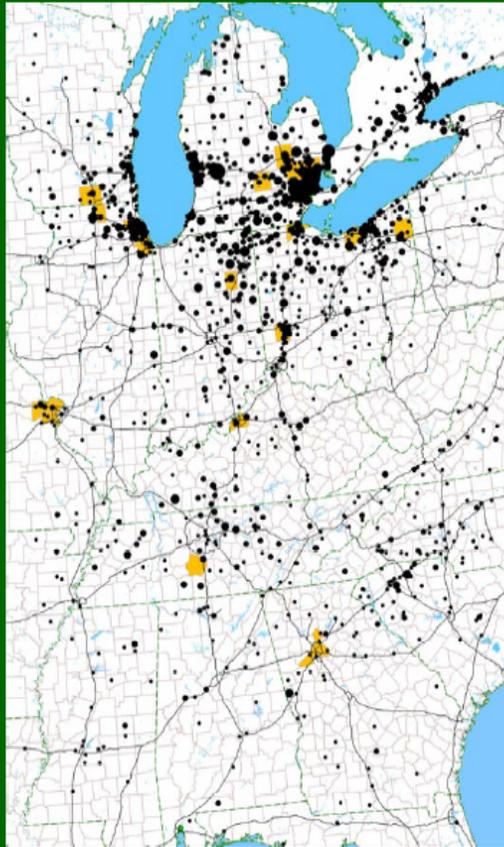
- Direct supplier jobs stood at 668,400 in 2005 – a 20% reduction from 1999
- MI lost 28% (to 162,600); Ohio lost 17% (to 93,900); and Indiana lost 21% (to 76,000)
- Job losses will stabilize once:
 - vehicle manufacturer market shares stabilize
 - capacity utilization reaches 90%
 - vehicle manufacturer supply bases are stabilized
 - off-shore sourcing allocation established

Source: US Bureau of Labor Statistics and CAR

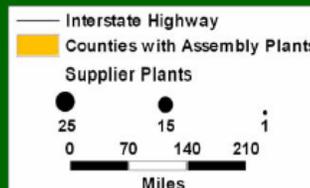
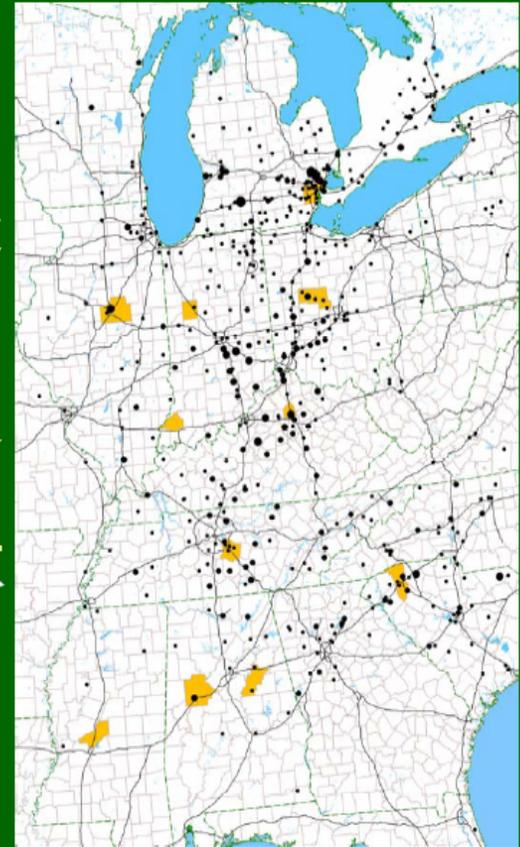


Supplier Investment Grows through U.S. Auto will remain an important economic engine

U.S.-owned suppliers are still centered around Detroit



But not foreign-owned suppliers



Source: Thomas Klier, Federal Reserve Bank of Chicago



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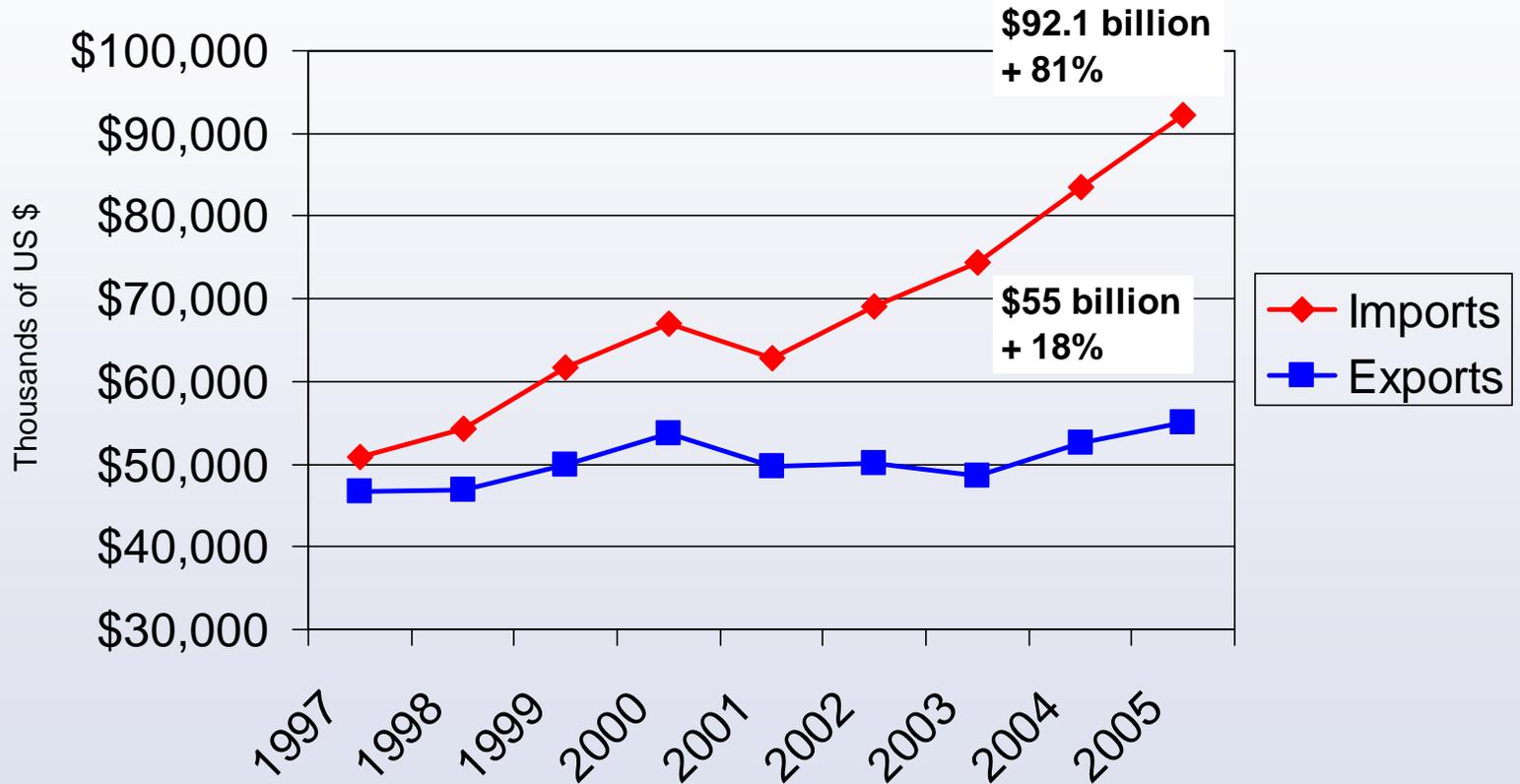


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US Automotive Parts Trade

Production mix and world capacity drive US imports

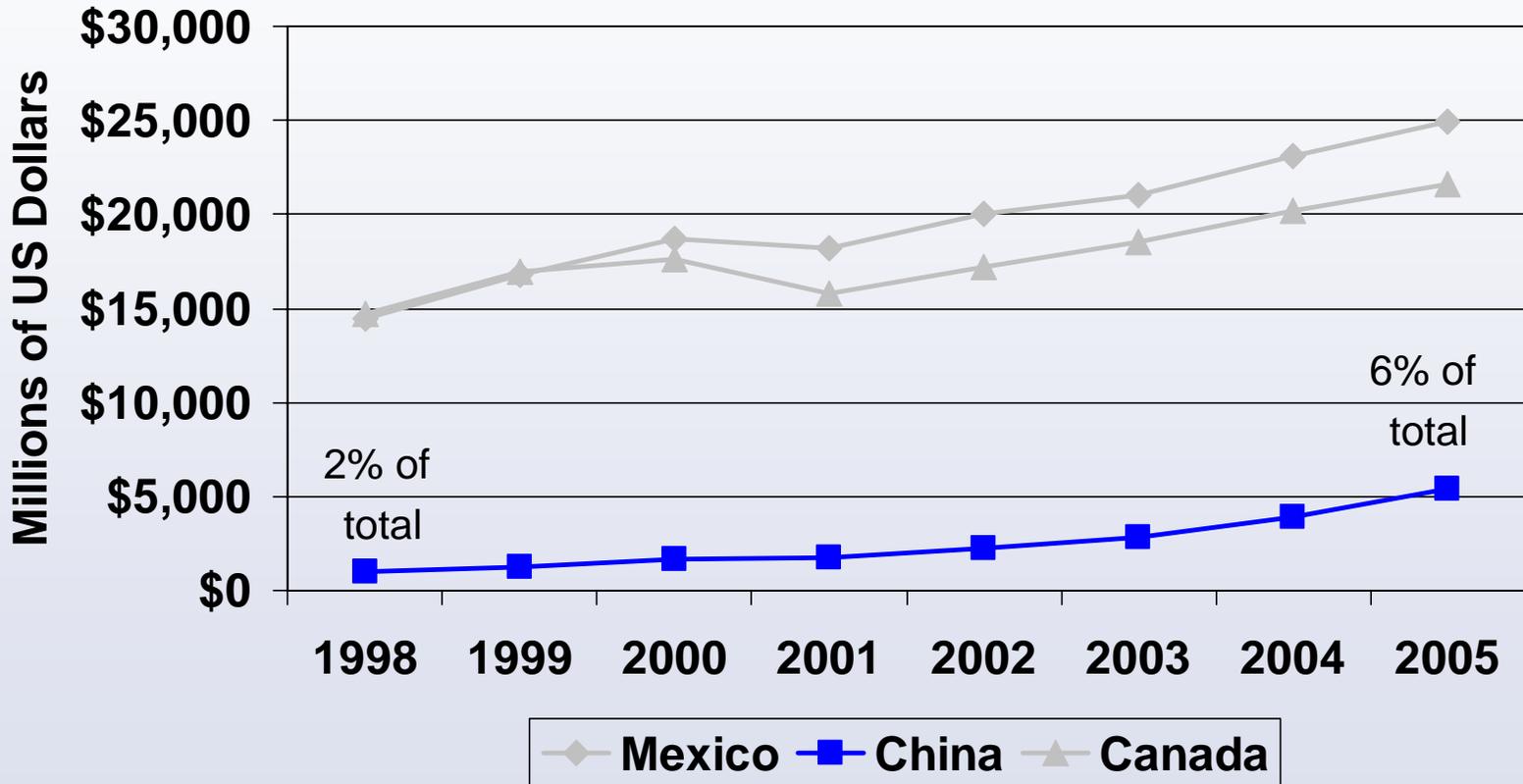


Source: US Department of Commerce, ITA



US Automotive Parts Imports

NAFTA partners remain 50% of US imports

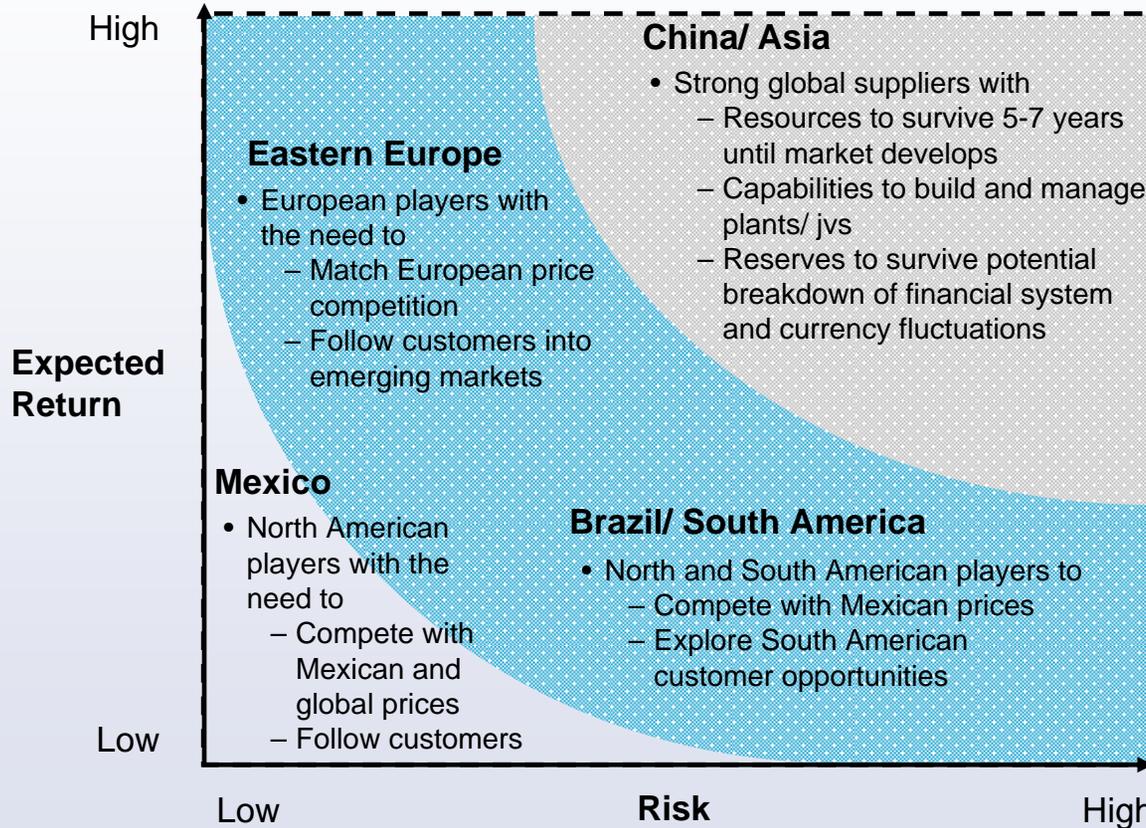


Source: US Department of Commerce, ITA



Risks and Rewards Vary by Region

Not all manufacturing will end up in China



Source: Roland Berger, The Odyssey of the Auto Industry, 2004



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Wage Restructuring

Moving to the norm? Or race to the bottom?

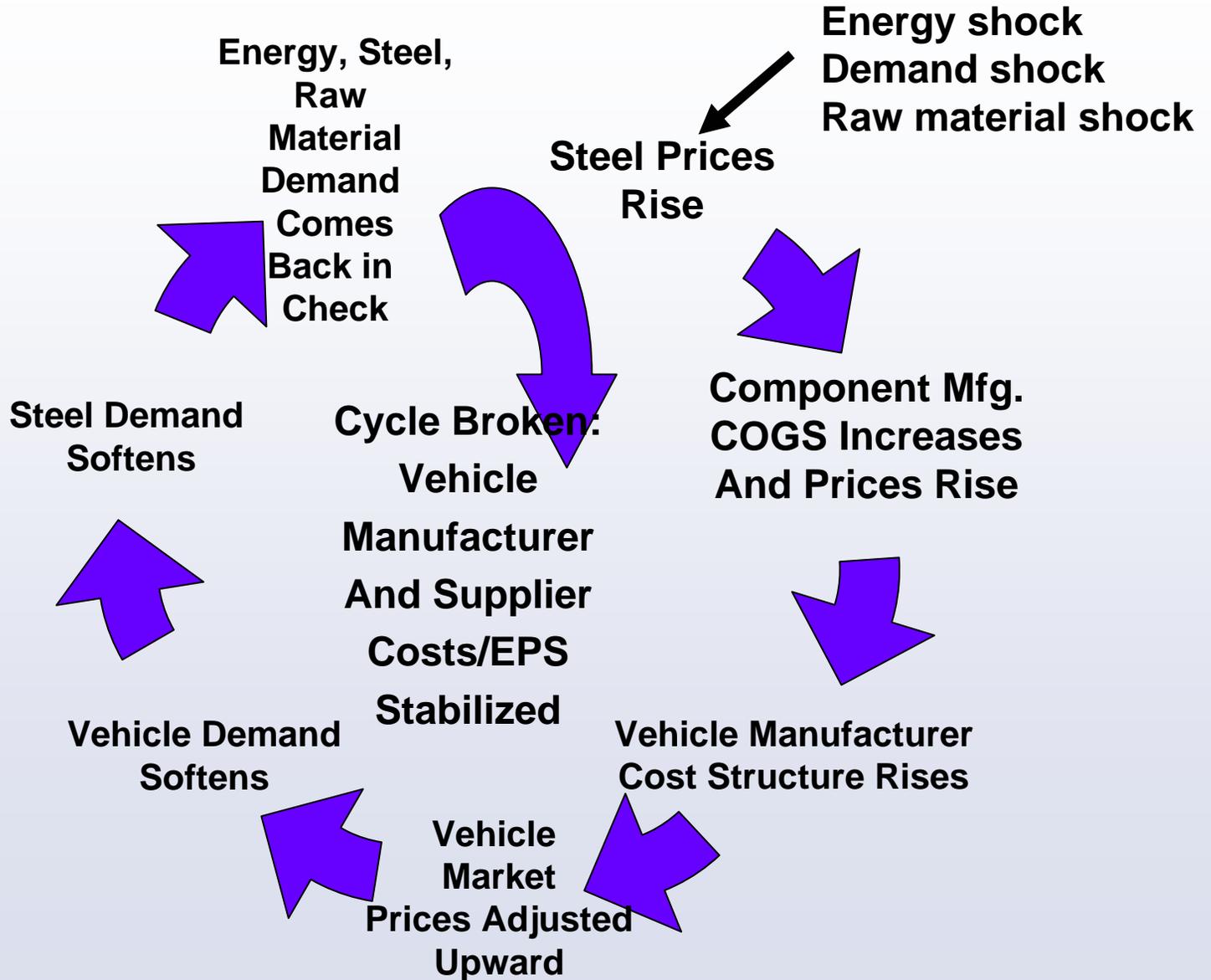


Note: Straight-time hourly wage rates. Motor vehicle parts includes Delphi and former Visteon contracts. Union or higher-tier auto parts jobs are typically in the \$14 to \$16 per hour range and lower-tier, non-union jobs typically run in the \$10 to \$14 per hour range. Delphi proposal may/may-not include a GM per hour subsidy – making proposal \$12.50/hour

Source: BLS, Census Bureau, CAR Research 2004

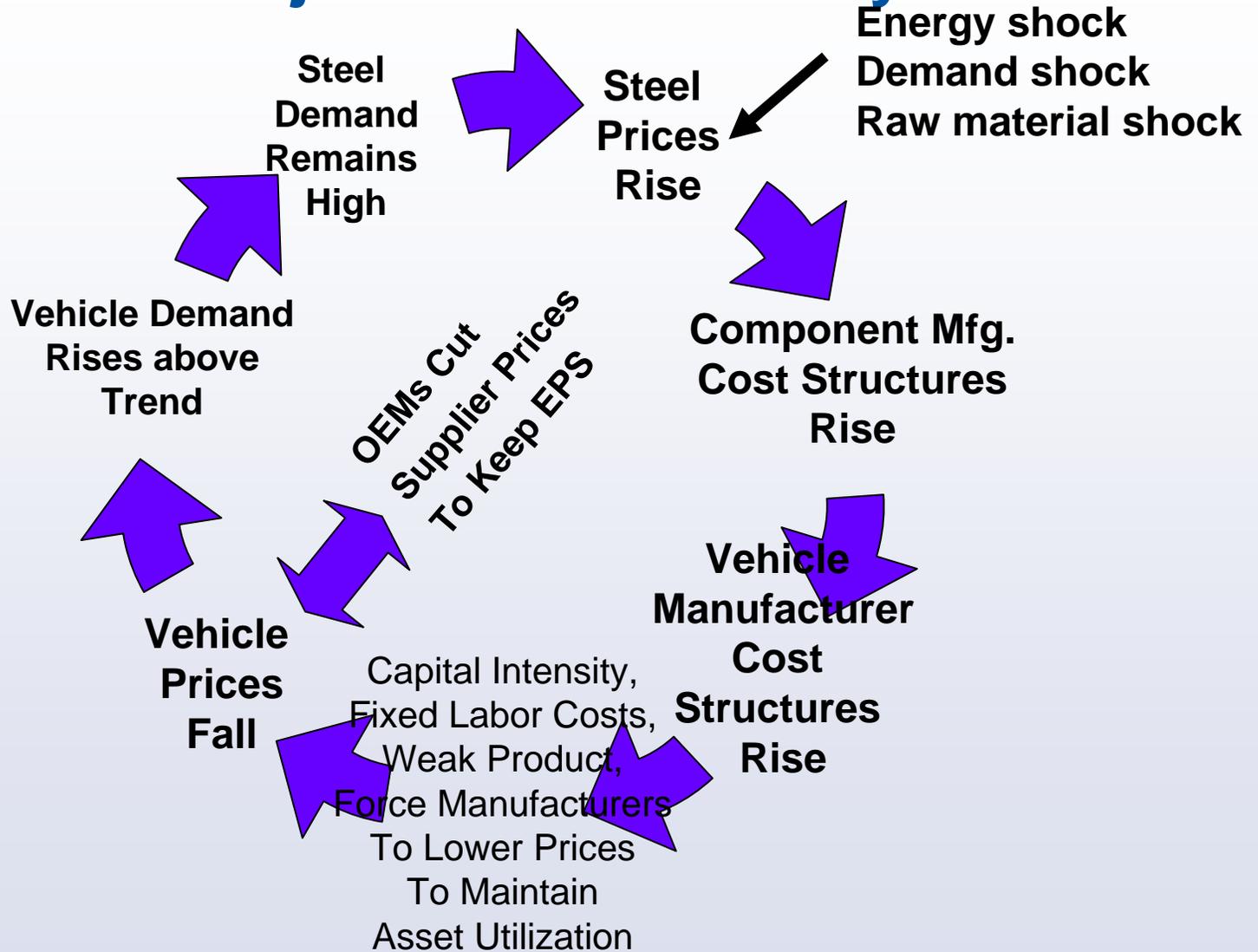


Price Adjustments: Economic Theory





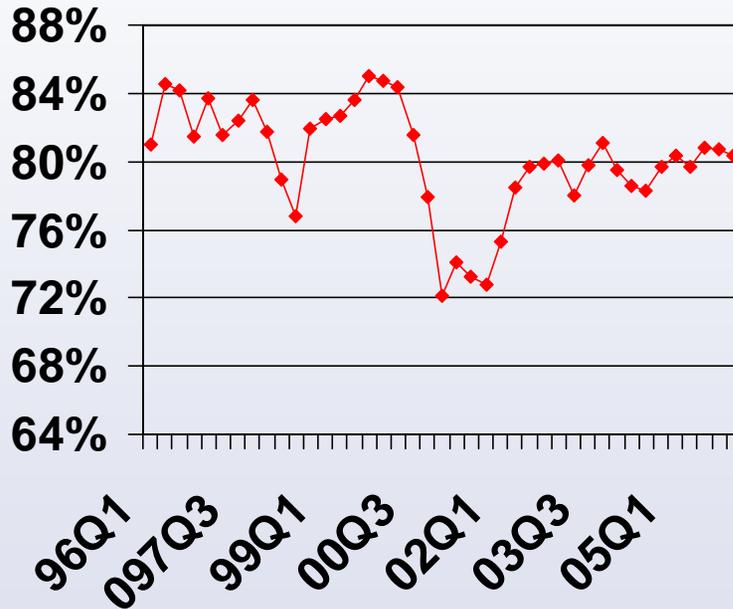
Price Adjustments: Industry Practice





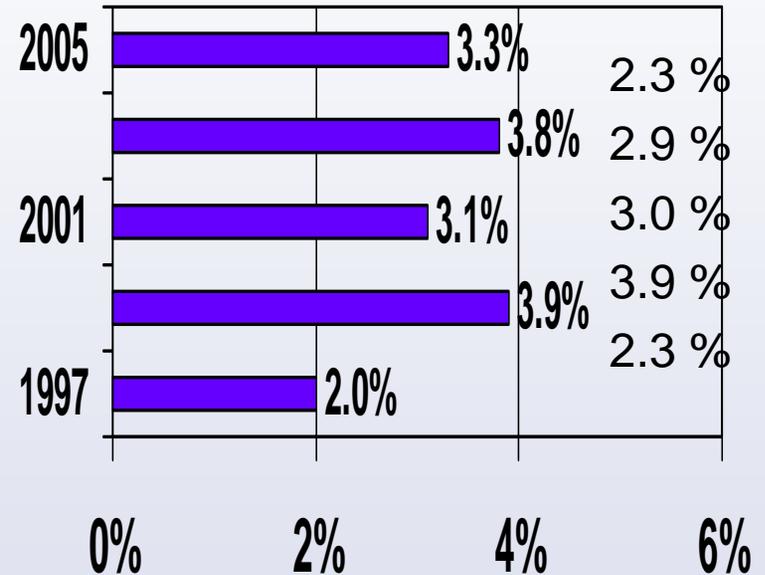
Utilization Improves through Rationalization Price Downs Equate to Productivity Growth

Motor Vehicle Parts - Utilization Rates



Source: Federal Reserve Bank

OEM Price Down Requests

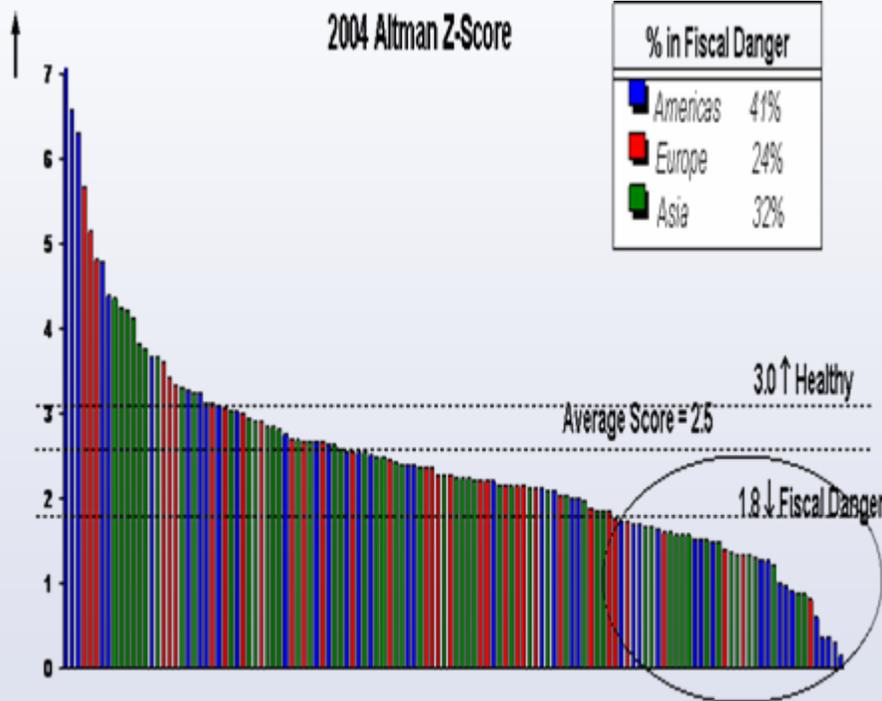


Note: Weighted average by NA production; numbers to right indicate % given to first tier suppliers

Source: IRN

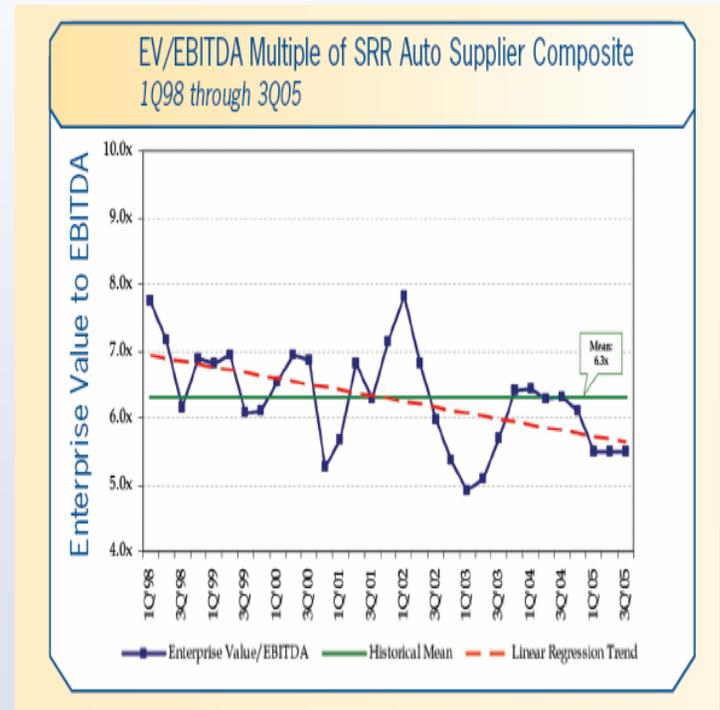


Liquidity Stabilizes on Operating Performance Valuations . . . Still at Risk



Source: AlixPartners analysis

Supplier Valuation



Source: Stout Risius Ross



Customer-Supplier Relations

The cornerstone to advance the industry forward

- 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)



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GONDORFF: You beat him, kid.

HOOKER (softly) You were right, Henry. It's not enough... But it's close.



The Industry Restructuring has Just Begun

It won't just "be close" for the ones that survive

- The national UAW contract is broken between vehicle manufacturers and component groups
- Labor, supplier, customer contracts opened in Chapter 11 proceedings
- Supplier wage tiers restructured at each stage of the value-added chain
- Corporate legacy costs significantly restructured
- Traditional domestic manufacturers and suppliers plant and office operations rationalized to increase capacity utilization
- UAW membership, wage, and benefit levels more difficult to protect in plant-by-plant environment
- Total compensation adjusted down to match value-add, new purchasing efforts established
- Compensation will be adjusted downward for some 10% of supplier employees; but not a wholesale decimation of the working middleclass
- Retirees forced to accept exclusively Medicare benefits; defined contribution plans dominate
- Suppliers and traditional vehicle manufacturers adjust to NA production share of under 70% from 82% - 2 million unit change from 1993 to 2005 and an additional 2 million unit reduction over the next 5 years



The NA Table of Pain

Business models must survive through . . .

Industry PPI/CPI/ECI	1998-2006 YTD % Change
New Vehicle CPI (through the dealer – includes incentives)	- 3.7%
Light Duty Vehicle Manufacturer PPI (to the manufacturer)	- 2.2%
Motor Vehicle Parts PPI-Commodities (to the supplier)	- 2.3%
Primary Metal PPI	+35.8%
Plastic Materials & Resins PPI	+73.1%
Oil & Gas Extrusion PPI	+300.4%
BLS ECI Benefits - Manufacturing	+46.8%

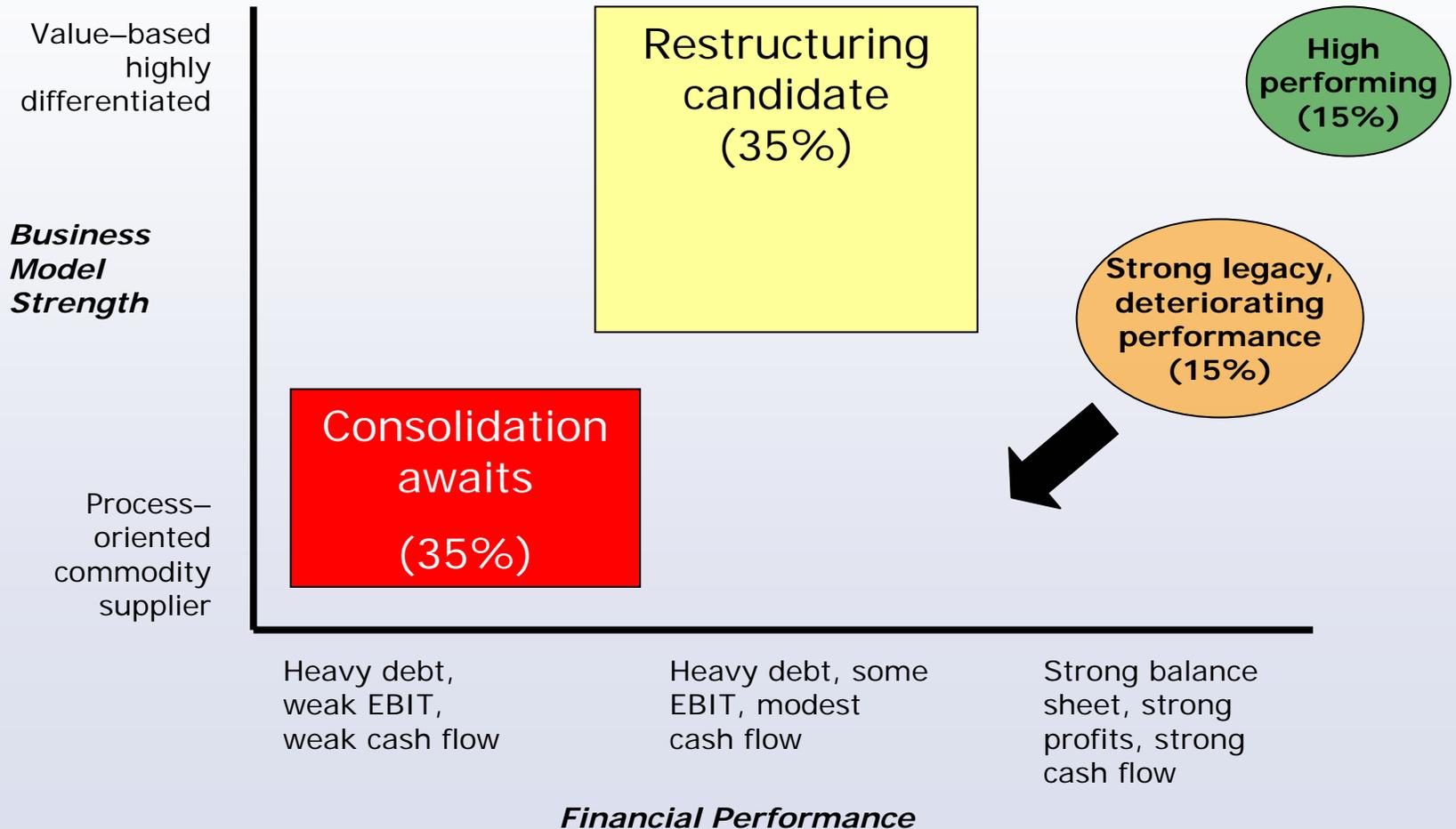
Source: CAR and OESA at the 2005 Management Briefing Seminar; Updated by OESA through March 2006

Note: Auto accounts for 41% of US steel consumption, 31% of US iron consumption, 32% of US aluminum consumption and 4% of US plastic consumption (CAR – Fall 2003 economic significance report)



Industry in Transition

Question: Who owns future capital / profit streams?

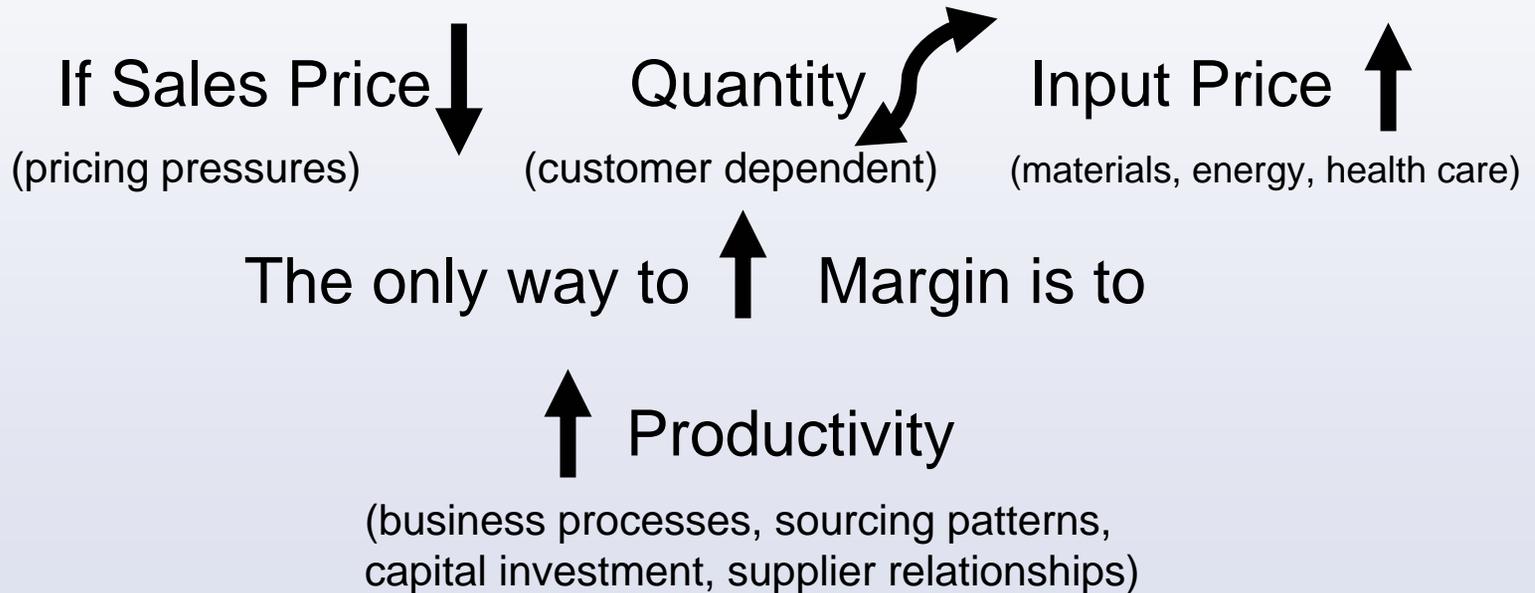


Source: Plante & Moran, PLLC proprietary data base, firm estimates



Economics 101

ROIC comes from productivity and value creation through innovation in supplier relations, business processes and product

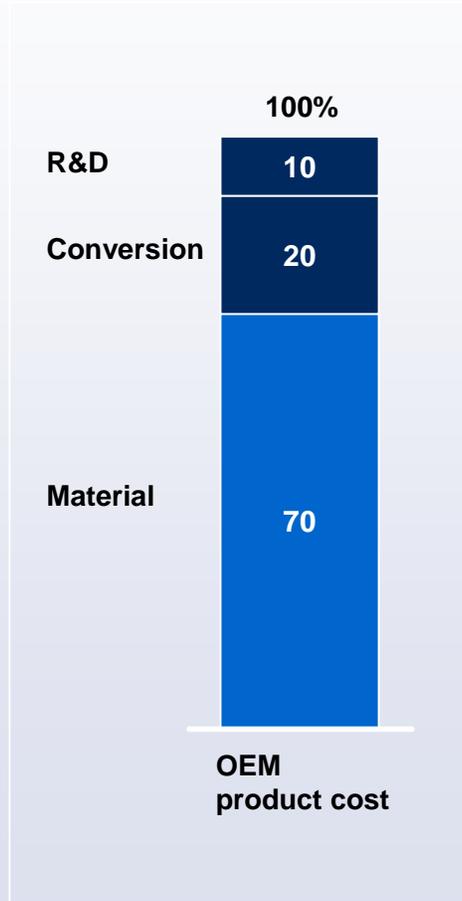




Customer-Supplier Relationships

Significant waste in the system

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



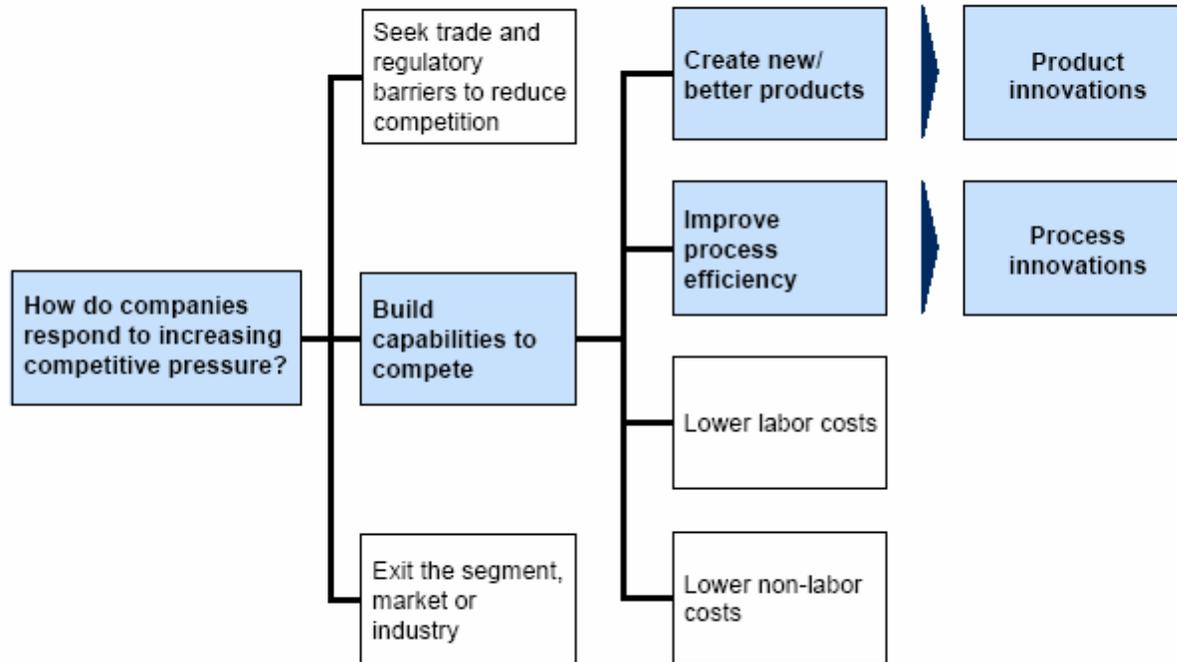


People, Product, and Process

Value creation opportunities exist throughout the supply chain

THREE WAYS TO RESPOND TO COMPETITIVE THREATS

□ Focus of this project



Source: MGI

Source: McKinsey Global Institute



Industry Time Line

Events shaping the industry's structure

- May 9 and 10, 2006: Delphi Sections 1113 and 1114 hearings on active and retiree contracts
- June 12, 2006: UAW Constitutional Convention
- June 23, 2006: Deadline for early retirement incentives for 113,000 GM and 13,000 Delphi employees
- September 1, 2007: 5,000 Delphi employees to have flowed back to GM
- September 3, 2007: Delphi wages reduced to \$16.50/hour plus \$50,000 “wage buydown” payment
- September 14, 2007: UAW existing contracts expire with Ford, GM, DCX, Delphi, and Visteon



Conclusions

- **Global perception is:** “The cost battle is set to be a race to the bottom, with the industry chasing ever-lower labour and input prices.” Max Warburton, UBS Investment Research, *European Automobiles and Auto Parts*, November 2005
- **Reality is:** All vehicle manufacturers are restructuring operations and re-focusing strategies to deal with increased competitive pressures in their respective home markets. These dynamics propagate through the supply chain and force changes to supplier financial viability and strategies.
- **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:** Improved working relationships between all customers and buyers to support near-term world production of 76 million vehicles and NA production of 17 million units of a product with increasing personal comfort and functional capabilities. If we can't make money then . . .
- **An honest return on invested capital will occur when:**
 - Production shares by manufacturer 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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