OLIVER WYMAN

INSIGHTS ON AUTOMOTIVE SUPPLIER EXCELLENCE

DRIVING GROWTH OF AUTOMOTIVE SUPPLIERS

MARSH & McLENNAN COMPANIES

DRIVING GROWTH OF AUTOMOTIVE SUPPLIERS

The automotive supplier industry is driven by a paradigm of continuous growth in the force field of changing business model requirements, customer expectations and shareholder needs. Successful companies are capable of achieving growth while at the same time increasing profitability. Nevertheless, not all companies are able to grow in a similar way, as they face very specific challenges and opportunities. Companies that realized the highest profitability growth in the past five years, were already large in size, able to leverage market trends and segment-specific dynamics – and had a sound understanding and strategy to address them.

Consequently, there is no "one-size-fits-all" solution: There is a need for specific directions and strategies, matching a company's maturity and individual positioning. The different growth options can be categorized in three main paths: Regional expansion, market penetration and portfolio extension. Each of these paths implies different benefits, challenges and risks. Across all potential dimensions, automotive suppliers should consider a set of key success factors when identifying, prioritizing and managing growth opportunities in order to make growth manageable and sustainable.

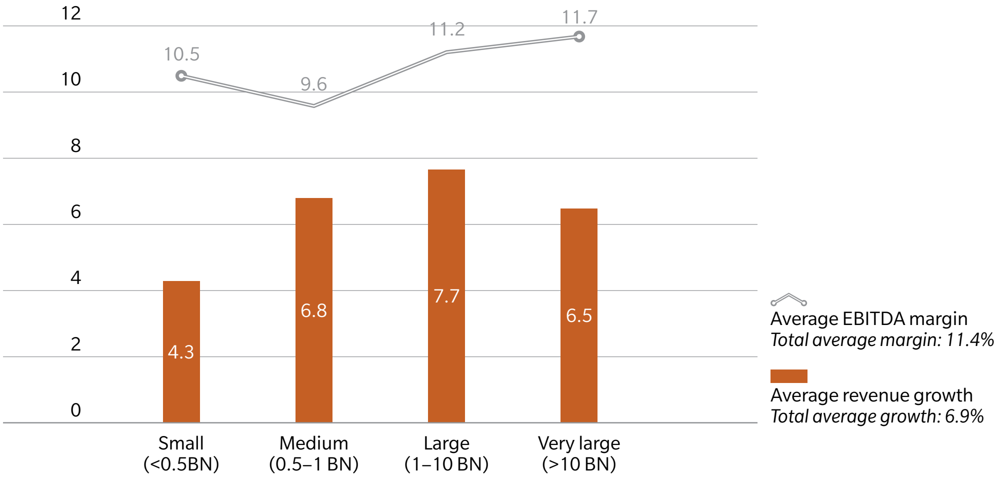
POSITIVE DEVELOPMENT IN THE PAST

The automotive supplier industry has been able to maintain prosperous growth in the aftermath of the global financial crisis. This growth has been achieved through widely different approaches that include expansion into new geographical areas, adding key new product lines, forming new partnerships, taking over rivals and professionalizing the organization.

The gains have not been limited to the top suppliers. Players of all sizes have benefited from growth. Oliver Wyman's analysis of automotive suppliers across the global value creation chain found the companies achieved average growth of 6.9 percent a year in 2011–2015 and had an average EBITDA margin of 11.4 percent during the same period (see Exhibit 1).

Exhibit 1: Revenue growth and average EBITDA margin by company size

REVENUE CAGR IN %, EBITDA IN % OF REVENUE , 2011–15



Source: Oliver Wyman supplier database

The open question is: What will be required to sustain this positive momentum?

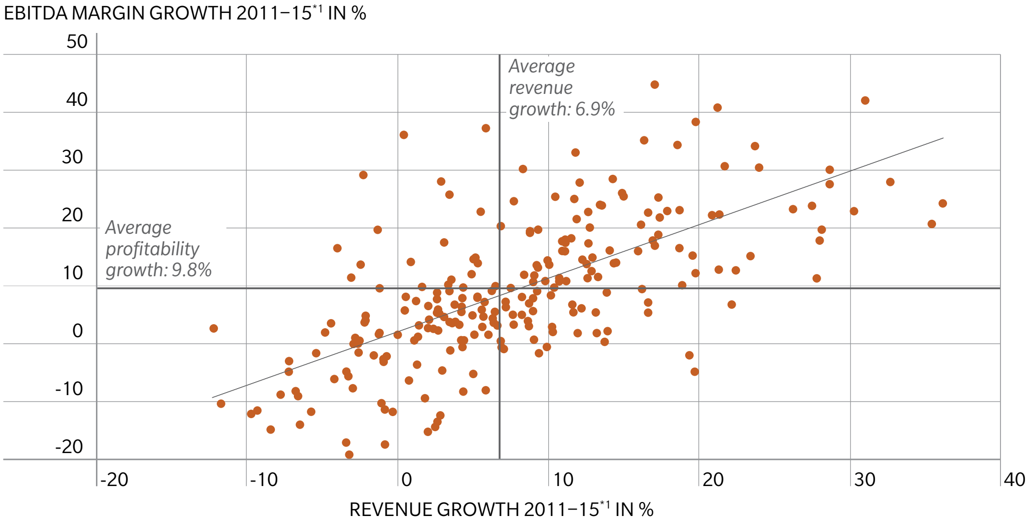
A key finding of Oliver Wyman's analysis is that growth and profitability are highly correlated to the company's size, the business segments the supplier competes in and his ability to leverage market trends. Successful automotive suppliers exploit the opportunities arising from these three dynamics, while also improving their profitability levels. But what makes these companies special? What are the key success factors to consider when coping with the challenges of growth? And ultimately: Why is growth important for the automotive supplier industry?

WHY GROWTH IS IMPORTANT

The success of industries in capitalistic economic systems is usually determined by a company's ability to increase both revenues and profits. This is particularly true for the automotive supplier industry. While a zero-growth strategy may succeed in the short term (e.g. in cases where the company wants to secure profitability or needs to reposition or restructure), in the long term the benefits of a unilateral focus on growth in this growing industry have been proven.

Oliver Wyman's financial analysis of supplier businesses revealed that companies that grow above the market average also increase profitability at a higher rate than rivals with lower growth rates. Suppliers achieving an annual growth of more than 20 percent between 2011 and 2015 managed to improve their profitability by 24 percent. Companies with average annual revenue growth of 6.9 percent or less during the same time frame achieved a profitability improvement of only 9.8 percent (see Exhibit 2).

Exhibit 2: Correlation of revenue and profitability growth 2011–15



*1 Growth measured as CAGR between 2011 and 2015

Source: Oliver Wyman supplier database

There are several business logic driven reasons that support the growth rationale.

- **Business model requirements:** On the one hand growing suppliers gain learning-curve effects, which allow them to leverage economies of scale, enhance price competitiveness and boost profitability. On the other hand expanding into a new, innovative niche can be beneficial because there are fewer rivals, which means more freedom in price setting.

- **Customer expectations:** Large automakers have developed highly sophisticated supplier management schemes. They are able to exert significant pressure on their suppliers. Additionally, to stay competitive and fulfill these high expectations, suppliers are under increasing pressure to support vehicle manufacturers' internationalization and cope with high-volume contracts on a global scale.

- **Shareholder needs:** Securing a sufficient equity base is a key priority for top management. This means convincing investors of the benefits of making an investment. Therefore, a sustainable development of the investment and a compelling growth story toward a potential exit can be valuable arguments. In addition, listed companies should optimize a series of key performance indications (KPIs) that need to be considered when taking fundamental decisions.

There are many quantitative and qualitative benefits that justify striving for revenue growth, making this an inevitable part of every automotive supplier's business strategy. However, growth also means significant challenges that must be managed. Depending on the selected growth path, companies may face a lack of resources and competencies, overstrained infrastructures, increased organizational complexity, or a potential clash of different cultures, to name just some of the risks.

INFLUENCING FACTORS: WHY THERE IS NO 'ONE-SIZE-FITS-ALL' APPROACH

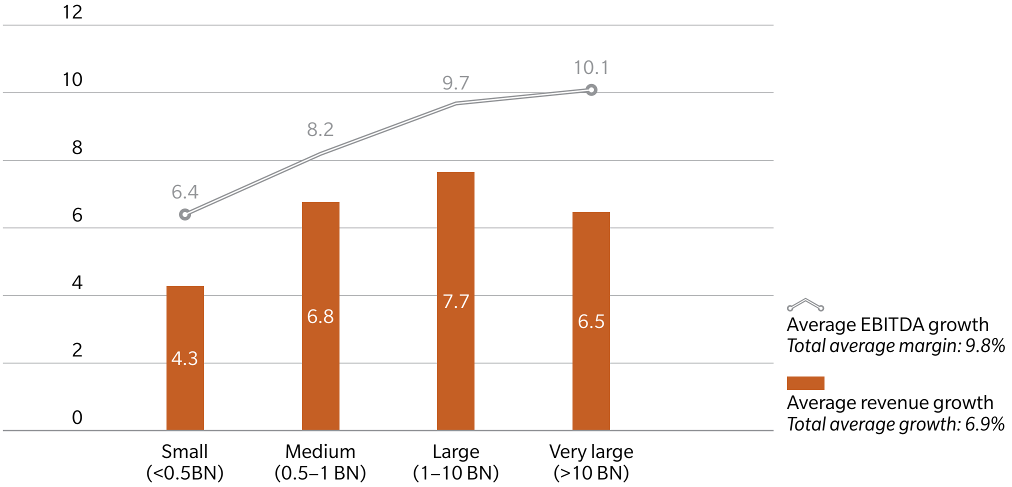
Since automotive suppliers have such diverse capabilities, their ability to cope with the challenges mentioned above varies. There are three key differentiators that determine the success of a growth strategy.

COMPANY SIZE

The size of the company affects its ability to both expand and maintain sustainable profitability levels while growing. Globally established, large-scale automotive suppliers with broad product portfolios and annual revenues of more than €10 billion naturally tend to have a lower organic revenue growth rate than smaller suppliers, which may be active in a limited number of markets selling a smaller portfolio of products. The limited growth opportunities for large players, however, are offset by their capability to realize above-average growth rates in profitability (see Exhibit 3). On the other hand small players with revenues below €500 million show lower than average revenue and profitability growth. Even in the bucket of players with €1–10 billion revenue, smaller suppliers below €5 billion are struggling to manage growth and may lose momentum. Such different performance in revenue and profitability growth is often driven by the larger suppliers' more sophisticated and mature structures, deeper and more experienced management teams and their large resource pools.

Exhibit 3: Revenue growth and EBITDA growth by company size

REVENUE CAGR IN %, EBITDA CAGR IN %, 2011–15



Source: Oliver Wyman supplier database

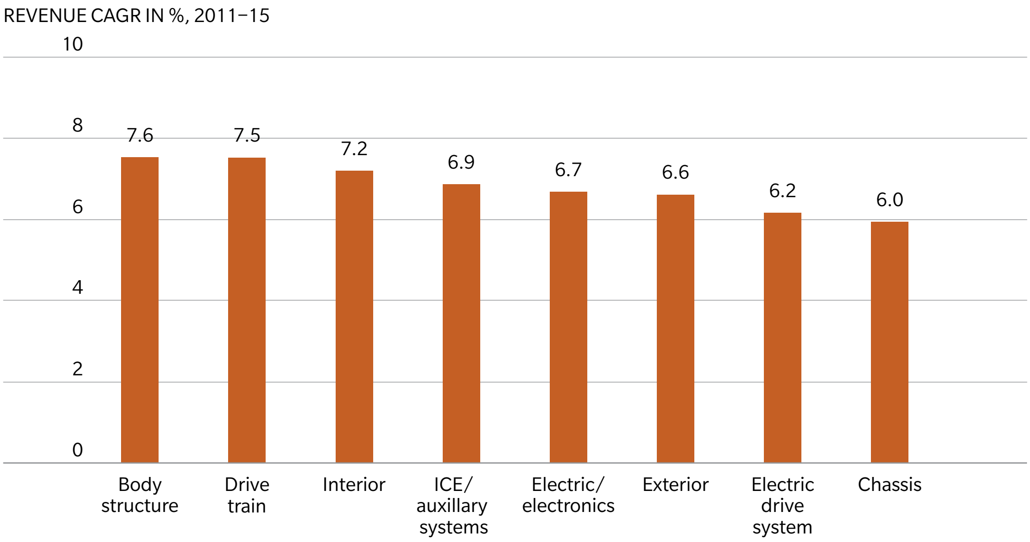
MARKET TRENDS

The automotive supplier industry faces various industry-changing market trends, creating a highly dynamic and challenging environment. The combination of a changing market environment (e.g. global shift of demand, cyclicality, and consolidation tendencies), rapidly developing technologies (e.g. connectivity, electrification of powertrains, autonomous driving) and a diluting customer base (e.g. the arrival of new automakers, changing partnership models, continuous cost pressure) pose significant threats to established business models. On the other hand, the ability to create opportunities by leveraging these market trends can be a key enabler of profitable growth.

BUSINESS SEGMENT

Growth in the automotive supplier industry is affected by the company's business segment (see Exhibit 4). While all segments are growing to some degree, the average revenue growth in 2011–2015 for supplier with body structure business was the highest at 7.6 percent, followed by those with drive train (7.5 percent) and interior (7.2 percent) business segments. All three proved to be considerably more successful than suppliers active in the chassis sector, where growth during the five-year period was just 6.0 percent. The growth rates are driven by segment-specific market trends or technology developments, and thus may change dramatically.

Exhibit 4: Revenue growth by module across all suppliers*1



*1 Growth rates per module include players that are active in multiple segments

Source: Oliver Wyman supplier database

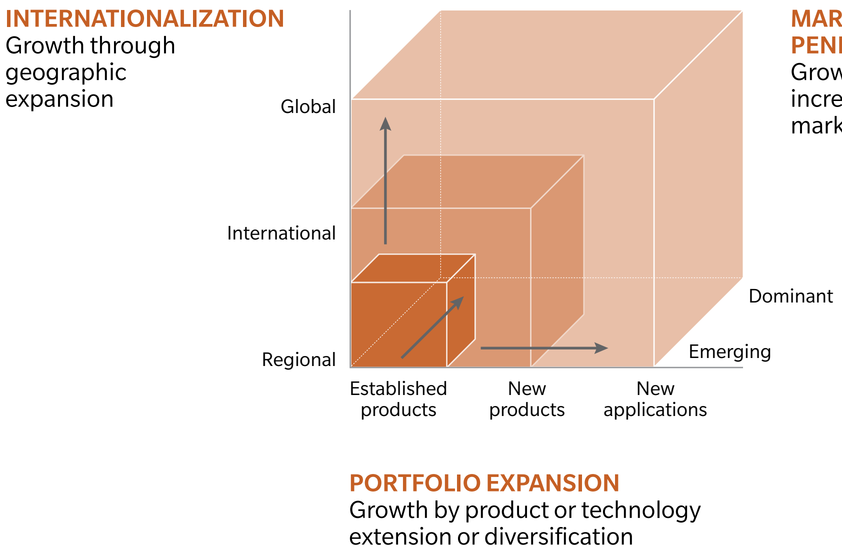
Unfortunately, growth of automotive suppliers is affected by various challenges and there is no „one-size-fits-all" solution that ensures sustainable revenue and profitability gains for all companies. To succeed, automotive suppliers need to follow different strategies, which will depend largely on the maturity of their businesses and their positioning in the market.

GROWTH PATTERNS: WHAT ARE COMMON STRATEGIES TO GROW?

There are three distinctive growth paths for automotive suppliers, as illustrated in the framework below (see Exhibit 5).

The first and most obvious growth path is to globalize the company's operations, either by greenfield moves, such as opening a new plant in a foreign market, or brownfield moves, such as utilizing existing structures via joint ventures or through mergers and acquisitions. The opportunities for growth through geographic expansion are determined by the size and setup of the company. While foreign operations make up about 80 percent of the total business at suppliers with more than €5 billion in revenues, this share is roughly 50 percent for suppliers with less than €700 million in revenues, thus offering a significantly higher potential for further expansion. Depending on the customer base, suppliers may also be forced to grow internationally to satisfy the expansion plans of their key customers. Executing on these demands can be especially challenging for small and midsize suppliers lacking sufficient organizational maturity.

Exhibit 5: Framework of growth patterns in the automotive supplier industry



Source: Oliver Wyman analysis

The second growth path is to deepen the company's presence in existing customer segments and geographies. This is done by increasing market share e.g. by gaining new customers in the same segment and expanding business with existing customers e.g. by winning additional contracts to supply key platforms or components. While this path is less risky it also has a smaller potential upside. To achieve relevant gains, suppliers need to strive for a mix of client-focused innovation and excellence in sales and service.

The third growth path is to expand the existing product portfolio by diversifying into new market segments, which often requires more aggressive strategies and additional stamina. This path is normally the most difficult, since it requires large investments, entails high uncertainty and relatively slow pay back. There is a wide spectrum of different opportunities, ranging from vertical integration along the value chain to the expansion into entirely new segments, potentially even beyond the automotive industry. The required investments and resources depend on the path that is followed. The less familiar the new segment, the higher the need to absorb external know-how. Empirical evidence shows that developing a new segment in-house usually requires three to five years, and it typically takes up to 10 years until critical mass and a positive business case is achieved. Common strategies to accelerate this time frame are to partner with a company that is already established in the sector or take over such a company. Thereby, suppliers create prompt access to new products, to new technologies or to new processes.

The above mentioned growth paths are rarely pursued individually. Ideally, they are part of a well-planned cadence of moves to ensure a successful overall growth trajectory. That being said, a targeted resource allocation based on a well-thought-out strategy is key.

KEY CHALLENGES FOR AUTOMOTIVE SUPPLIERS TO GROW

Driving and maintaining growth forces automotive suppliers to overcome many obstacles. Oliver Wyman has identified four key challenges that companies must tackle.

1. **Identifying growth opportunities:** Finding the right growth opportunity or the "blue ocean" that contributes to achieving performance targets represents a key challenge for an auto supplier as this opportunity must fit the company's setup and its desired risk exposure. Auto suppliers need to define the approach to identify and get access to growth vectors. This could include opportunistic "cherry picking" outside the automotive industry. Moreover, suppliers must have a stringent methodology to evaluate and prioritize potential opportunities.

2. **Selecting the right business model:** Typically, auto suppliers have access to multiple growth options – be it through market penetration, portfolio expansion or internationalization. Key challenges, however, are to develop the right business model and protect profit upsides – especially, while building up capacities that could put prices under pressure. Other key challenges to realizing profitable growth are speed – to achieve first-mover advantages – and creating synergies with the company's core business.

3. **Building the right set of competencies:** Allocating the right number of employees who possess the right competencies is often very difficult for auto suppliers, especially when the company wants to enter a new market or compete with a new product where the technology footprint and customer requirements are different. Establishing sufficient management capacity and freeing up top management to focus on the new venture is as challenging as securing the required funding to invest in the new areas. Building the capabilities to actually tackle the operational tasks at hand is equally challenging.

4. **Managing risks and complexity created by growth:** To grow, auto suppliers need to make educated, strategic bets on new technologies, new geographical regions and new market niches. This increases complexity and risks. Companies need to clearly understand their risk exposure and actively manage it. When they are growing, many companies struggle with rising complexity in their organizational setup, infrastructure and processes. Strategic trade-offs arise whenever there is high potential for revenue and profit growth. The risk and complexity needs to be managed proactively.

KEY SUCCESS FACTORS: HOW TO GROW SUCCESSFULLY

Generalizing success factors for growth is difficult because there are so many factors and situations to take into consideration at each company. There are, however, common steps that automotive suppliers should follow to expand successfully:

Systematic identification of growth sectors: Automotive suppliers need to strive for a comprehensive understanding of the market. However, understanding the own segments is not sufficient – it is imperative to anticipate disruptions and identify future profit zones that the company can tap, even those that are outside the firm's comfort zone. On the one hand the company must fully understand the current market trends and the drivers of value migration. On the other hand the organization must have insights into unmatched customer needs and competitor behaviors. Today, auto suppliers need to learn from rapidly growing companies, e.g. digital firms and consider the potential value of disruptive technology, e.g. new and emerging mobility concepts.

Prioritization of growth options: Successful growth requires rigorous prioritization of options in order to avoid a dilution of resources and management focus. Successful players focus on profitable growth and avoid "growth at all costs." Therefore, automotive suppliers need to establish a stringent prioritization methodology based on the assessment of upsides, risks and on how the new opportunity will fit within the company's core business. Growth strategies need to be a top management responsibility to ensure fast decision-making, which will reduce time to market and give the company first-mover advantages. A long-term roadmap is imperative, in combination with a comprehensive risk assessment.

Ensure maturity of the organization: The ultimate success of growth strategies is determined by the ability of the organization to manage the multifaceted challenges that accompany growth. This requires a superior organizational effectiveness, mature and efficient processes as well as stringent and consistent change management. Most important, however, is to understand critical competency and capability gaps (in terms of assets, IT infrastructure, talent, and more) early on and to address them by setting up the required resources. Successful auto suppliers leverage talent from other industries as well as support from external experts. Finally, if the targeted growth strategy fails, companies should have a fallback plan prepared to help them exit and redirect the company's focus elsewhere.

CONCLUSION

The automotive supplier industry has enjoyed five years of growth following the global financial crisis. Companies that focused on boosting revenue were rewarded with substantially higher profit growth than those firms that increased sales at a more gradual pace. Expanding into new regions, gaining share of wallet in the established business areas and adding new products aimed at meeting the needs of megatrends offer big rewards but also provide significant challenges and risks. Suppliers with a well-structured plan to identify, prioritize and implement growth options are in the best position to overcome those challenges and achieve success.

CONTACTS

LARS STOLZ
Partner, Head of the Automotive Supplier Team, based in Munich
lars.stolz@oliverwyman.com
+49 89 93949 434

DR. LUTZ JÄDE
Partner, based in Munich
lutz.jaede@oliverwyman.com
+49 89 93949 440

DR. JUERGEN REINER
Partner, based in Munich
juergen.reiner@oliverwyman.com
+49 89 93949 577

DR. TOBIAS EICHNER
Partner, based in Munich
tobias.eichner@oliverwyman.com
+49 89 93949 774

JOHANNES BERKING
Principal, based in Munich
johannes.berking@oliverwyman.com
+49 89 93949 744

CHRISTOPH MÖLLER
Principal, based in Frankfurt
christoph.moeller@oliverwyman.com
+49 69 97173 489

JOERN A. BUSS
Partner, based in Detroit
joern.buss@oliverwyman.com
+1 248 45572 46

MARC BOILARD
Partner, based in Paris
marc.boilard@oliverwyman.com
+33 1 450232 19

HUNTER WILLIAMS
Partner, based in Hong Kong
hunter.williams@oliverwyman.com
+852 2201 1700

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm's 4,000 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com. Follow Oliver Wyman on Twitter@OliverWyman.

ABOUT THE ARTICLE SERIES

Oliver Wyman's Automotive Supplier Team is the sole consultancy dedicated to total supplier excellence. Our team consists of experts in strategy development and implementation, sales, development, purchasing, supply chain management, production as well as EBITDA improvement, restructuring and M&A in the automotive supplier industry.

To highlight key trends, strategies and implications, Oliver Wyman is publishing a series of articles focused on major functional areas that are facing a strong necessity for fundamental change, including footprint, engineering, organizational excellence, restructuring, and purchasing.

OLIVER WYMAN