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The changing nature of auto industry restructuring

BY ALAN TILLEY

When GM and Chrysler both filed for Chapter 11 earlier in the year, there was a very real concern that the fallout down the supply chain would result in many other bankruptcy filings. The auto industry being international, the concern was real on both sides of the Atlantic. However, the initial concern has yet to be realised. Tier 1 bankruptcies have been few and far between. What could have been a domino effect throughout the industry has for the time being been averted. Major challenges still exist but it seems that action from all the industry's stakeholders has brought an element of stability into a depressed market. But questions remain: above all, when will the demand for cars improve and how will the industry manage the long haul back to a balance of demand with available capacity?

Estimated 2009 global vehicle assembly at 60 million units, down from 69 million in 2007 and 66 million in 2008, hides the real extent of the problem for the established manufacturers. Global utilisation was estimated to be 18 percent below capacity in 2007 and, with new capacity coming on stream in emerging markets, OEMs have to consider expensive factory rationalisation at a time of increasing financial stress. By this year, excess capacity is estimated to be over 33 percent in an industry with already high break even points.

Further down the supply chain the pain is more intense as OEMs have squeezed margins to bursting point. But, faced not only with reduced volumes, both OEMs and their suppliers are having to address a geographical shift from west to east and a demand for smaller, more fuel efficient cars. Add to this the political pressure to go 'green' with hybrid and non internal combustion engine models and the requirement for structural change is enormous.

Back in the early 90s, as other industries faced up to structural change, the solution was often brutal. With the possible exception of the US, where the Chapter 11 regime was more geared to preservation of enterprise value, banks and creditors forced companies into formal insolvency at an early stage in the process. In the auto industry, at Tier 1 level with JIT and sole supplier practices, this often led to administrators demanding price hikes and emergency funding under threat of supply disruption. This pattern continued into the early part of the new millennium despite the changes in insolvency legislation introduced by governments as a response to the previous 'slash and burn' era. But as the 2008 downturn hit the industry, the stakeholder balance changed. Excess capacity in the supply chain enabled OEMs to resist hostage payment demands by resourcing. Companies falling into administration or Chapter 11 quickly fell into liquidation or US Chapter 7 and disappeared.

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As we moved into 2009 the challenges posed to management were enormous. Firstly were the simple questions: where is the market going, where is the bottom, and what are the OEM volumes likely to be in the weeks and months ahead? To establish business viability, companies needed a production plan upon which to base a business model. That in itself was almost impossible given the uncertainties. Forecasting cash flows and survival models was very much an exercise in guesswork. That more companies did not file for bankruptcy was both a major surprise and achievement.

By mid 2009, action by governments in the US and Europe had brought an element of stability to the process. 'Cash for clunkers' had reversed the demand slide. Government loans and bail outs had restored some liquidity to the supply chain. Work sharing, short time and other flexible labour initiatives reduced operating costs and cash drain. Temporary factory shut downs had reduced inventory levels. OEMs were able to keep their supply chains liquid. And banks, often under government pressure, held back from bankruptcy action.

Revisions to bankruptcy laws were also tested. In Germany, the government relaxed its balance sheet test of insolvency which had previously caused precipitate filings. In Spain, the government introduced a temporary automatic stay against creditor action ahead of formal filing to allow restructuring to take place. In France, a similar process known as 'sauvegarde' had been available for two years. In the UK, insolvency and restructuring professionals had evolved responses such as pre-packs, often derided by affected creditors, but in practice a useful tool to avoid unnecessary value destruction.

In retrospect it could now be seen that filing for bankruptcy was very much a last resort. In the case of GM it was used only when it became apparent that no consensus for downsizing plants and negotiating out of onerous legacy costs would be reached with senior creditors and labour unions. The Bankruptcy Court was used to force home a solution of a viable core entity enabling a leaner 'New GM' to emerge while the bankruptcy process resolved the problem of excess capacity. Similarly Chrysler reorganised under a pre-pack. In Europe, the GM reorganisation has seen only one subsidiary file – perennial loss maker Saab, whose demise had been predicted for some time. Even the Swedish government stepped in to protect jobs and a white knight has been ▸▸

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found, albeit on a reduced scale.

But, as Q3 2009 draws to an end and the German government bailout of Opel Vauxhall through the Magna takeover seems to be heading for reluctant EU approval, we have only reached a resting point in the process; a chance perhaps to draw breathe as managements face the enormous challenges of reducing capacity, moving production, introducing new, cleaner models – all in the face of extreme financial pressures. One if not two GM Europe factories must close and the political battles to achieve this will be interesting. And other companies, such as Jaguar Land Rover, face excess capacity issues.

Other major challenges lie ahead at Tier 1 level. Delphi has still to exit from Chapter 11 and adjust to life where its main customer is under new ownership. Continental and Schaeffler still have major issues to resolve in their merger. Moving production from Western Europe to Eastern Europe is coming under tighter scrutiny for many suppliers with government agencies supplying lifeline cash support less enthusiastic to see employment move to other countries. Many of the old certainties are now being challenged. It looks like it will be well beyond 2013 before capacity utilisation will be restored to 2007's levels. And by this time China will have overtaken the US and Japan as the largest manufacturer of light vehicles in the world.

We have seen turbulent times with manufacturers fighting for survival. But governments, employees and banks have responded to the challenge. Above all, stakeholders at all levels have grasped the realisation that live companies are worth more than dead companies. The more flexible insolvency regimes in most jurisdictions have at least given today's management teams more of a fighting chance than their predecessors in other challenged industries had in the last recession. ■

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