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ROUNDTABLE

AUTOMOTIVE SECTOR

The trials of the automotive industry are widespread and deep-rooted. Tightening credit markets have restricted financial flexibility. The supply chain continues to present challenges. Western manufacturers are up against the growing might of Asian rivals, particularly from China and India. As they vie for dominance around the world, they are looking to cut costs, jettison legacy obligations and boost declining profits. They must meet the changing demands of consumers, such as improving fuel efficiency. Operational and restructuring solutions will be paramount in the years ahead, and some degree of industry consolidation is expected among manufacturers, suppliers and dealers

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THE PANELLISTS

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What are some of the major developments you've witnessed in the automotive sector over the last year?

Denkowicz: The major developments I have seen over the last year are centred on branding, consolidation and media offerings. The proliferation of an excessive number of models with overlapping market prices within the same brand is responsible for consumer confusion that the automotive manufacturers are now trying to eradicate by eliminating some models. There is also continued consolidation among suppliers to reduce costs at every step of the manufacturing process and an emergence of high end entertainment centres in vehicles as a major option designed to attract the young generation of buyers.

Overbeek: Over the last year, Chinese car manufacturers have made beginners' mistakes by exporting unsafe vehicles to the EU without having sufficient type approvals and by using the wrong distribution channels. But they are learning fast. They know that design, quality and safety are top priority and that they can only sell attractive vehicles that are safe through reliable distribution partners. They will be back soon. Perhaps the most important recent development was the introduction of the Tata Nano, a vehicle sold at such a price that it will become available for millions of people. Other manufacturers will follow. As a result, it will have a major influence on natural resources. This will be the trigger for fuel and drive line alternatives.

Andrews: The major development in the automotive supply base in the past year is that a perfect storm can indeed become more perfect. For example, low volumes as a result of declining market share for the Detroit based automotive original equipment manufacturers (OEMs) can grow lower still as overall industry volume declines. Raw material pricing pressures can continue over extended periods of time and financing pressures reach a peak just when the other factors impacting the supply base reach their peak.

Chadwick: The lead story in the automotive sector over the past year has been the impact of tightening credit markets. The inability to easily access new sources of liquidity has and will continue to restrict companies' financial flexibility and the increasing cost of new capital will consume greater amounts of limited cash flow. Companies that are attempting to restructure are unable to find new financing and are facing a catch-22; choosing between extended uncertainty and inadequate investment leading to the inability to qualify for new business or selling assets at fire sale prices. The increasing costs of debt service may force a bankruptcy filing.

Savini: Automotive suppliers emerging from restructuring processes are adopting progressively more conservative capital structures. This trend is less reflective of the suppliers' enlightenment than it is an increasing requirement imposed by key constituencies, including OEM customers, trade vendors and creditors. Historically, these constituencies have not placed maximum financial leverage conditions on companies undergoing a restructuring, but increasing instances of Chapter 22 filings in the industry seem to have made them less apt to remain passive on such important issues.

Kelly: A key event in 2007 was Cerberus, a US private equity fund, purchasing the Chrysler Brand from Daimler Chrysler for a fraction of what it was valued at a decade before when it merged with Daimler Benz. In the UK, the troubles for Ford with their Jaguar and Landrover brands have dominated the headlines. Both marques have a chequered history of losses and late response to markets. Both the new XF and redesigned Freelander have won awards, but the challenge will be to maintain their development so that they stay ahead of the competition. 2008 will see new owners, and all eyes will be focused on what influence they exert on these brands. BMW may have made their first mistake with the highly successful Mini, with a Mini Traveller that has been heavily criticised by some of the automotive press.

Gordon: One of the major developments in the past year was the development of the voluntary employees beneficiary association (VEBA) as a partial solution to the burdens of staggering employee benefits obligations. Not only has this solution improved the prospective health of balance sheets such as Delphi's, it has potentially transformed the United Auto Workers union (UAW) into the manager of a significant fund and a potential investor in the marketplace. Another significant development was the continued investment in the industry by private equity and hedge funds. The recent actions taken by a Cerberus-owned Chrysler leading up to the Chapter 11 filing of supplier Plastech Engineered Products in Detroit may be a harbinger of new approaches to troubled supplier issues and supply chain management.

Butler: Three developments in 2007 stand out looking ahead to 2008 – the increased influence of private equity and hedge funds, more pressure on production and sales volumes and an organised labour agreement to establish VEBAs and provide OEMs and suppliers with healthcare and other post-employment benefits (OPEB) relief. It is hard to overstate the correlation between volume and the general health of the sector. Leading industry analysts estimate that there will be less volume generated in the coming year than in any year in the last decade. The volume pressure will be mitigated somewhat by deals made last year on legacy OPEB and healthcare issues by OEMs and major suppliers. For a number of key industry players, there is a new chief in town and 2008 will be the first real test of private equity's leadership in the sector.

In what ways has the credit crunch and capital markets volatility impacted the ability of troubled automotive companies to attract financing?

Chadwick: The tightening credit markets have forced troubled companies to rethink how they structure their balance sheet. For example, lenders are more cautious, no longer loaning at leverages of 3.5x to 4.0x EBITDA. Valuation multiples have declined. This means that there is less value and forms of currency to allocate among the creditor classes, making negotiating a restructuring much more difficult. The challenge of trying to appease creditors on the one hand and create a capital structure that provides sufficient liquidity and financial flexibility on the other can derail the restructuring process. Companies that attempt to maintain historic debt levels risk creating a much more complicated restructuring with higher costs of debt and longer stays in bank-

ruptcy, greater risk of 'Chapter 22's' and loss of customer and vendor support.

Butler: With rare exceptions where there was committed financing already in place - and the arrangers determined to fund notwithstanding the macroeconomic changes in the capital markets - leveraged financing for non-investment grade companies was largely unavailable during the last half of 2007 and will continue to be very challenging in 2008. The automotive sector also remains out of favour with investors at the moment in part based on 2008 production and sales volume estimates. On the other hand, it is important to recognise that the current capital market dislocation does not mean that the intrinsic value of automotive suppliers and manufacturers is altered in any fundamental manner, but there are clearly short term liquidity challenges across much of the industry. For the short and intermediate term, covenant-lite, PIK toggle interest and other borrower friendly loan terms are history. Pricing has increased dramatically. However, there is a lot of unemployed capital sitting on the sidelines in the capital markets that will be put back in play at some point.

Savini: The credit crunch and capital markets volatility have almost eliminated the market for rescue and exit financings for automotive suppliers. Investors willing to do the work on investment opportunities and put capital at risk in the sector are focusing on the secondary market or just sitting idly by waiting for a signal a floor has been reached. Primary or new issue financings for troubled automotive companies are seen to be less desirable on a relative value basis, because they involve an added element of execution or turnaround risk that's not likely priced in the offered yield.

Gordon: The credit crunch and capital markets volatility have certainly increased the cost of capital, and while they did not precipitate significant bankruptcy filings in 2007, the effects may manifest themselves more in 2008. Moreover, we are seeing the impact of this volatility in the difficulties experienced by Delphi and others in securing exit financing. Hopefully, this volatility will begin to calm by the end of the first quarter of 2008.

Andrews: Financing, particularly for the supply base of the automotive industry, is extremely challenging, and likely to remain so for some time. Along with a general tightening of overall credit, continued headlines of declines in the automotive industry, and deterioration in the performance of the supply base, financing for automotive parts suppliers, whether troubled or otherwise, is extremely difficult. Some companies are languishing in bankruptcy, with no clear way to the exit, and all other financings, regardless of their character – DIP lending, exit financing or refinancing – are more expensive, harder to get, constrained in amount and more covenant rich.

The credit crunch and capital markets volatility have almost eliminated the market for rescue and exit financings for automotive suppliers.

DURC SAVINI

Kelly: We have yet to see the full effects of the credit crunch, as it takes time for existing financial arrangements to come up for renewal. It will have significant influence as we move further into 2008, and it will affect the whole supply chain. As the profits of the financial institutions and their reputations have been badly hit, they will be far more risk averse in their lending criteria, and some themselves will have a lack of availability even if they had the will to lend. Closer financial relationships will be necessary for some to survive and in the supply chain we could see some significant restructuring. The effects could be most keenly felt by Chrysler and Ford. Chrysler as it comes to terms with its new financial arrangements and Ford as it seeks to negotiate the final sale of Jaguar and Landrover.

Denkowicz: Much of the automotive industry is dependent on factory supported leasing programs. The subprime mortgage mess has the potential of spilling into other consumer credit arenas, of which the automotive sector is the most visible. As securitisation rules are tightened and rating agencies scrutinise the deals more closely, the ability to offer factory leasing incentives will decline. This will have a negative impact on one of the most important financial tools for the automotive companies. Similarly, tougher credit standards imposed by independent lenders with respect to purchase programs will result in disqualification of a consumer group that previously could have qualified for financing.

What impact has the weakening US dollar had on the global automotive industry?

Kelly: The majority of cars made in the US are still sold in the US. The benefits of the weakened dollar will not have such a beneficial effect, as would otherwise be the case. US marques have always represented good value, but have failed to break into the global market in the way one would have expected. The US economy will slow the automotive market in the US, and the relatively expensive imported models will give a slight edge to the traditional US marques.

Butler: Besides adding additional financial pressure to US based manufacturing operations, many US companies with global businesses have actually benefited from more favourable foreign exchange rates in connection with manufacturing and sales generated outside of the US.

Overbeek: The weakening US dollar has meant that US cars have become cheaper on export markets, which has given taunted US car manufacturers some breathing space.

Savini: Most non-North American automotive companies doing

business in the US are seeing their profits squeezed. This is particularly true for Canadian automotive suppliers that manufacture products in Canada for delivery to US assembly plants. Canadian currency appreciation in relation to the US dollar over the last couple years has severely harmed the cost competitiveness of Canadian automotive suppliers. If this trend continues and global OEMs increasingly embrace world price sourcing initiatives, the Canadian supplier sector will likely experience a significant shake out.

Gordon: From the vantage point of Detroit, the impact just to the north in Canada, for example, has been dramatic. The cost of Canadian parts to US automotive manufacturers has drastically increased, resulting in demands by OEMs for significant price givebacks by Canadian suppliers. This has had a devastating impact on many Canadian automotive suppliers.

Denkowicz: The relative strength of the euro versus the dollar is evident on the sticker price of comparable high end cars in the US. So far, it is hard to say whether the European OEMs are adversely affected by this result in the US. Nevertheless, the long-term implication is that, in terms of market growth, European high end manufacturers will feel the impact, particularly if the US enters a recession. The currency fluctuations do not appear to have hit US based suppliers to the same extent because they have been forced over many years to be close to the manufacturing operations and their sales are in the currency of the country in which they operate – other than those whose manufacturing facilities are located in Canada. However, on a consolidated basis, suppliers reporting earnings in a currency other than US dollars will feel the impact of reduced earnings flowing from US operations on their financial statements.

Chadwick: For the OEMs that manufacture in Europe and Canada and import into the US, including Ford, the weakening dollar has negatively impacted margins. While the dollar has weakened against the Japanese yen, the relative strength of the US dollar versus the yen has continued to buoy the importation of Japanese manufactured cars. However, from a relative cost structure perspective, the US dollar would have to free fall in value in order to begin to bridge the gap in labour costs in the US and Canada versus Mexico, Eastern Europe and Asia.

Andrews: The weakening dollar will put pressure on profits of the foreign OEMs, especially those importing a large portion of their vehicles. They will have little leverage to increase prices unless the domestic OEMs comply with a price increase of their own. This may also result in the foreign OEMs with domestic production capabilities buying more parts domestically or enticing their foreign suppliers to locate production domestically. Those foreign OEMs without domestic production may now consider building production capacity in North America. In addition, suppliers located in countries whose currency has appreciated versus the dollar, such as Canada and Europe, face immediate financial risk where their contracts are paid in US dollars – even where a foreign supplier is hedged, either through payment in its local currency or through financial instrument means. Over the longer term, they will find it increasingly difficult to compete against US based suppliers taking natural advantage of the weakened US currency.

Long-term value investors are seeking companies that have specialised, value added products that are difficult to outsource.

PETER CHADWICK

Can you describe the role that both financial and trade buyers are playing in the industry? How have their strategies and activities changed in the past 12 to 18 months?

Chadwick: Both financial and strategic buyers have become far more selective, focusing on potential value buys, where companies are at low valuations, and strategic buyers seem more likely to avoid taking on more debt in order to take on the challenge of integrating a distressed competitor. Long-term value investors are seeking companies that have specialised, value added products that are difficult to outsource. Globalisation is another key strategy.

Denkowicz: Financial buyers have clearly yielded their seat at the table to the strategic buyers in all industries and the automotive industry is no exception. There has been growing concern by financial institutions during the last six months in terms of lending to a private investment vehicle, as opposed to a strategic buyer, although credit appears to be tight as a general rule. Moreover, the strength of the foreign currencies in relation to the US dollar makes it even more attractive for foreign strategic buyers to be on the acquisition trail in the US even if, temporarily, the currency conversion will have an impact on consolidated reporting overseas. On a long term basis, the strategic buyer will benefit from a lower purchase cost with the potential of improvement in currency exchange rates in the future and, in the end, a strategic buyer cannot give up market share in the most significant world market.

Savini: Financial buyers in the US have become more sophisticated participants in the market for control in the automotive sector over the last 12 to 18 months. Lately, they are more apt to avoid broad auctions and instead cleverly seek quasi-private control investment opportunities under the aegis of a significant constituency. Centerbridge Capital Partners' $750m equity investment to recapitalise Dana Corporation through its bankruptcy process is a prime example of this phenomenon. Recognising that Dana's restructuring would involve significant wage and benefit relief from its major unions, Centerbridge courted the UAW and United Steelworkers Union (USW) as an exclusive funding source for the overall labour settlement. In return, Centerbridge offered to assist

labour with the settlement negotiations and agreed to provide post-emergence governance that protects labour's interests. Apaloosa Management pursued a similar strategy in the Delphi case, but rather than courting labour, they courted General Motors (GM) regarding their settlement interests. This is a smart approach – something we'll see more of in the restructurings to come.

Andrews: We may see a return to the model of the strategic buyer, and a de-emphasis of financial buyers. The days are gone when a pure roll-up strategy, aided principally by financial leverage, can create value in the automotive space. Acquisitions today need to be very operationally focused. Otherwise, the acquirer is taking a tremendous risk, for which it almost certainly will not be rewarded.

Kelly: Over the last 12 to 18 months the financial buyers have made significant inroads into the automotive sector. During this time, the trade buyers have been outbid, unable to compete with the massive funds available in the financial sector. All is now likely to change. The financial buyers will no longer have the resources available and some will be struggling to come to terms with the high prices they have paid for their acquisitions. The next 12 to 18 months will be a difficult period as funds for acquisition, whether in the financial sector, or for a trade purchase, are going to be hard to come by.

Do you expect to see further consolidation? Which areas or segments will be most active and what motives will underpin these deals?

Andrews: Further consolidation in the automotive supply base, especially in its most commoditised segments, is a certainty. Plastics is an area where consolidation is imperative. Haul away carriers is another area where large segments of the supply base are troubled. In that environment, it is difficult to see how consolidation can be avoided.

Butler: There will be continuing consolidation across most segments of the industry but the timing of these transactions may be tempered by the availability of capital on favourable terms in the short term.

Consolidation domestically will be driven in part by continued overcapacity and low cost alternative countries.

ROBERT D. GORDON

Denkowicz: Consolidation is taking place at three levels. First, there is consolidation among competitors in the parts industry. This has been the case for some time and will continue. However, the OEMs have the final word on the extent of consolidation they will tolerate as no one wants to be dependent on a single source and the ability to have several competitors serves as a governor over price. The second element of consolidation relates to the 'branding' issue. The number of competing vehicles, even within the same OEM family, is cannibalising sales from one another or, even worse, causing consumer confusion and lost sales. Hence, there will be more of an effort to reduce the number of low volume models to consolidate the offering to the consumer and extend the price differentials between models. Finally, the dealership structure needs to be examined given the web-based alternatives to the traditional sales outlet and the ability to shop multiple dealers without leaving your desk. From a legal standpoint, this is an area of intensifying interest in the US in terms of consolidation, although the ability of the automotive manufacturers to make headway is dependent on a myriad of state laws.

Savini: Automotive supplier consolidation will be with us for years to come, especially among North American suppliers with large big three – GM, Ford and Chrysler – exposures. As big three production schedules continue to decline, crowded out by import and foreign badged vehicles produced in the US, supplier capacity currently dedicated to big three vehicle programs will have to be either re-tasked to transplant production or be rationalised and consolidated to remain profitable serving domestic manufacturers' smaller defensible product offerings. The pace of consolidation activity will likely be further galvanised by big three purchasing organisations increasingly adopting global sourcing programs aimed at achieving the lowest landed cost without regard to proximity for a given component or module. Once fully implemented, these programs will result in numerous production dislocations in the US supply chain as significant automotive part sourcing moves overseas and south of the border.

Gordon: I would expect to see further consolidation of the tier two and tier three supplier bases in 2008. It seems that some of this consolidation was deferred beyond 2007 as tier one suppliers such as Delphi, Dana, Dura, and Tower sought primarily to stabilise their supplier bases and preserve the status quo during the pendency of their Chapter 11 bankruptcies. However, as these companies emerge from bankruptcy, it would seem that some additional consolidation will occur. Consolidation domestically will be driven in part by continued overcapacity and low cost alternative countries. Moreover, it has been suggested that the continued development of common vehicle architecture and common global components will necessarily lead to a reduced supplier base. Most of this consolidation should be horizontal in nature, as it seems widely acknowledged that vertical consolidation too often creates unwanted challenges.

Chadwick: The confluence of restricted capital markets, declining production volumes, particularly for Ford, GM, and Chrysler, and continued overcapacity in North America, will provide opportunities, if not necessity, for continued supplier consolidation. Companies that have not rationalised capacity and moved production to lower cost countries are particularly at risk. Despite the

amount of consolidation in the interiors space, there will continue to be acquisition activity there as some of the financially weaker players find themselves with few strategic alternatives.

Overbeek: I do not immediately foresee further consolidation among European and North American car manufacturers, though it is not at all impossible that one or two will go bankrupt. Some years ago the idea was that the market would end up with four or five big car manufacturers and that the market would become an oligopoly. The European legislator took this risk as one of the main motives to introduce stricter competition rules in this sector. But the feared oligopoly has not surfaced. We have seen that two out of three initiatives, Daimler/Chrysler and GM/Fiat, have already been reversed, while some of the most profitable car manufacturers are small niche players. Further consolidation, however, is to be expected among Chinese car manufacturers, and it is not unthinkable that a Chinese or Indian car manufacturer will takeover a European, Japanese or North American OEM. At the retail level, I expect further consolidation. The commercial power that big retail groups have in relation to car manufacturers has had more effect than any competition regulation.

Kelly: There has to be further consolidation to compete in the marketplace. Indian and Chinese manufacturers are seeking to consolidate their growth with more international marques which can reduce the cost of manufacture, and deepen their penetration of international markets.

What threats and opportunities have new entrants, particularly from Asia, presented to struggling automotive companies in developed markets? How will this dynamic shape the industry in the years ahead?

Gordon: Foreign money and foreign entrants provide a ready source of liquidity. Tata's acquisition of Jaguar and Land Rover and the Russian investment in Magna are significant examples in 2007. More entrants, however, may lead to a more diverse and fragmented market. This, in turn, may force domestic automotive manufacturers to focus on smarter, smaller portfolios to narrow the field of competitors for their products.

Overbeek: In the EU, Asian manufacturers have caused increased profitability of distribution networks, which took on board these brands additionally. As a result, some struggling automotive companies have been able to survive due to the fact that their distribution channels continued to sell their products along with Asian products. As a matter of fact, they have benefited from each other. The Asian brands have benefited from the existing networks, while the existing networks have benefited from the Asian players. The distribution of vehicles has not undergone much change over the past decades. Most car manufacturers have adopted exactly the same methods of distribution. However, this has not made it impossible for new OEMs to enter the market. New entrants are in a position to come up with innovations that the European legislator has only dreamt. They do not have existing distributors that resist change and could, if they wanted, turn things around. They could save a lot of distribution costs and let the web play a much bigger role. It will be interesting to see if any one of them will take this opportunity. If one does, others will follow.

Asian entrants have had an impact on the pricing of vehicles and the extension of warranties. However, if price were the only consideration that resulted in the sale of cars, the US manufacturers would have been bankrupt long ago.

STEPHANIE DENKOWICZ

Savini: New entrants to North America from Asia, in particular Korean manufacturers, offer incremental and relatively quicker customer diversification opportunities to struggling, big three dependent suppliers in North American. Japanese transplant manufacturers have historically been a hard sell for leveraged tier one automotive suppliers. Even well capitalised big three dependent suppliers have found the sell-in process to Japanese transplants to have uncharacteristically long gestation periods in relation to other non-North American manufacturers. On the negative side, while their early models fell flat in the North American market, principally for aesthetic reasons, Korean automakers are now making significant strides in capturing market share from the big three as their designs continue to improve, especially in the coveted mid-size SUV and crossover segments. Some believe this has galvanised the big three to focus more intently on design and given birth to successes like the Ford Edge and GM's Buick Enclave.

Denkowicz: Asian entrants have had an impact on the pricing of vehicles and the extension of warranties. Their lower cost structure and absence of long term liabilities arising from legacy healthcare benefits is advantageous, whether they import or manufacture in the US. Moreover, the offer of extended vehicle warranties has had an impact on the extension of warranties by some US manufacturers. However, if price were the only consideration that resulted in the sale of cars, the US manufacturers would have been bankrupt long ago. Obviously, there are other elements in the equation.

Kelly: Low manufacturing costs in Asia are the greatest threat to any struggling automotive company in a developed marketplace. The opportunity will be either strategic alliances or to develop smaller niche products that attract a premium. We have witnessed the resurgence of the Bentley brand in the UK and internationally, and some manufacturers may have to consider producing fewer niche products to survive.

Andrews: Strategic foreign buyers, however backed, are active players in today's M&A activity in the automotive sector. While these players represent a threat to their domestic counterparts, they are not generally as nimble. Of course, one could also read ▸▸

that as they are less inclined to do a deal for deal's sake, they are less likely to make a mistake.

Chadwick: I still think that we are several years from seeing a real impact in local markets from the emergence of major manufacturers in developing countries. The Asian suppliers and OEMs have a North America focus on the acquisition of intellectual property. On the other hand, developing countries are becoming the new battleground for North American suppliers and OEMs. While the Chinese market is still fragmented and immature, North American OEMs and tier one suppliers are increasingly investing in developing local production in order to service the Chinese consumer. The long-term trend is remarkably familiar however. The newer entrants will focus on the low end of the market, forcing the more established participants to go more upscale, creating new competition at that level.

What weaknesses exist in the structure of the automotive industry? Has the supply chain become too interdependent, for example? How can existing problems be resolved?

Overbeek: The car manufacturers have used their purchasing power to squeeze their tier one suppliers to the point that small problems can lead to the bankruptcy of suppliers, who were already in a difficult position due to overcapacity and the enormous increase of models. Because of the increased dependency on these suppliers, car manufacturers have been forced to take certain rescue measures in order to avoid an abrupt cessation of serial production, thereby spending a lot of money that they initially intended to save.

Savini: Industry supply chain problems are less structural than managerial in my view. By that I mean the OEMs haven't historically fully participated in managing the weaknesses in their supply chains when opportunities, such as restructurings, have presented themselves. The focus seems to have been to passively mitigate risk associated with a bankruptcy restructuring process than to affirmatively leverage their customer position to direct optimal outcomes – low post-emergence financial leverage in standalone recapitalisations, sale of assets to better managed, underutilised competitors, etc. This has been changing over the last couple years, but not nearly enough to achieve the real benefits available to the OEMs from a supply chain rationalisation perspective.

The automotive industry has to be increasingly wary that its actions can represent the proverbial straw that breaks the camel's back – production interruptions due to stress in the supply base is ever closer.

KRISS ANDREWS

Kelly: There is a very open relationship along the supply chain within the automotive industry. However, it needs to develop a better understanding of the financial dependence they all have on each other, and be more prepared to assist an ailing company in the chain. They also need to understand that interdependency is not necessarily restricted to the direct supply chain, but extends to exterior suppliers. The costs of interruption and replacing suppliers can be substantial, yet the costs of some financial assistance can be relatively small by comparison.

Andrews: The supply chain is interdependent, but even with the degree of stress we see today, the OEMs have generally avoided shutdowns and production interruptions. However, the automotive industry has to be increasingly wary that its actions can represent the proverbial straw that breaks the camel's back – production interruptions due to stress in the supply base is ever closer.

Gordon: The interdependence of the supply chain is inherent in the manufacturing process. The weakness is in the lack of collaboration in the sharing of costs and research and development initiatives. So, for example, presently, when raw material prices increase, they become only one party's problem, rather than the shared long-term responsibility of all participants in a given supply chain. The shift by OEMs to preferred suppliers may be one way to change the relationship and dynamics between the OEMs and their suppliers and create a more collaborative process going forward.

Chadwick: As a result of consolidation and supplier distress, the OEMs have been forced to renegotiate some contracts with their suppliers. However, the fundamental economic disparity between the suppliers and OEMs still exists. The suppliers carry the burden of making major dedicated capital equipment and engineering investments in new programs. This leaves the suppliers exposed to the risk that volumes decline or do not meet OEM forecasts upon which part prices are negotiated. Until the OEMs decide that suppliers should be compensated based on a reasonable return on invested capital, including engineering capital, we will continue to see these waves of distressed suppliers.

Denkowicz: One source of weakness arises from the failure to align the government mandates imposed on the automotive industry with the consumer demand. The automotive industry has been squeezed between the need to offer fuel-efficient vehicles in order to satisfy government regulations and the failure of the consumer to respond favourably to such vehicles. This has placed the automotive industry in a quandary – required sale of efficient vehicles to meet government regulations sold at deep discount or loss, while offsetting the loss with higher priced but less fuel efficient vehicles which the customers demand. The easy answer is that the automotive manufacturers should have produced efficient, yet desirable, vehicles but that is too easy given inherent limitations in fuel efficiency, performance and the resulting design challenges. These issues are now coming to the fore as US consumers are reacting to the economic reality of petrol prices that will likely be with us for the future. As a result, the changes we will see in the

coming years will more realistically address the weakness caused through the interaction of government mandates, consumer taste and the vehicles offered by the OEMs.

To what extent are labour agreements, healthcare costs and other legacy obligations hampering the competitiveness of automotive companies in established markets? Has any progress been made on this front?

Butler: Ask any of the major US based OEMs and suppliers, and they will all point to legacy obligations, particularly pension, healthcare and other OPEB obligations, as a major competitive disadvantage. The good news is that some of the major supplier restructurings over the last several years and the quadrennial labour agreements with the OEMs negotiated in 2007 are all transforming the industry. The new union VEBAs and related relief given to the OEMs are extraordinarily meaningful. There is more wood to chop in this area, including federal statutory and regulatory relief.

Savini: Prior to the 2007 labour contract negotiations, legacy obligations have unquestionably hung like a millstone around the necks of the big three, impairing their ability to flexibly respond to production declines with commensurate cost reductions necessary to preserve profits. The concessions gained in these contract negotiations will move the big three closer to cost competitiveness with their transplant competitors, but not nearly to a point of parity. Relief from go forward retiree healthcare obligations was the centrepiece of the deal struck with the UAW, yet these benefits won't be realised in great measure until 2010. Importantly, more and more large tier one automotive suppliers like Dana and Delphi are addressing their uncompetitive labour cost issues as well through their bankruptcy restructuring processes. The templates of these deals are all relatively similar and will serve as a guide for the next round of restructurings.

Denkowicz: The expeditious resolution of the labour strikes last year is evidence that the labour unions and automotive companies each recognise the necessity of addressing problems regarding the legacy costs. Everyone at this point appears to understand the need for cooperation. This problem did not develop overnight and it's not going away next week. There are many parties involved in structuring a solution and it is beneficial that the unions have taken a responsible stance and a share of the economic burdens. To the extent that everyone in the process takes a long term view and assumes responsibility, the impact of solving these issues can be spread over a sufficient number of years and different stakeholders to find the best possible solution.

Gordon: There is no doubt that significant strides were made in 2007 to reduce labour related costs in the US. However, I am told that the average hourly combined wage and benefit paid by the domestic automotive manufacturers still averages in the mid $50 range and needs to be reduced to the mid $20 range in order to be competitive in certain segments of the workforce. I am somewhat sceptical as to whether this can be achieved, particularly in the short term before further jobs are relocated to lower cost countries. The situation is even more challenging in Canada, where there are no VEBA's and the average hourly wage and benefit totals approximately $80.

Chadwick: OEM healthcare costs continue to rise as a result of the overall increase in average healthcare costs and the aging workforce demographics. It's the single largest factor driving the movement of production to low cost countries. It impacts the entire supply chain, as the OEMs have to look to their suppliers to help support this burdensome cost structure through price downs, uneconomic program awards and insufficient reimbursement for engineering investment. Despite the renegotiated union contracts, the legacy costs will continue to burden the big three. For example, GM's workforce, the oldest in the industry at an average age of 50, will have over 180,000 workers eligible for retirement in the next five years.

Major supplier restructurings over the last several years and the quadrennial labour agreements with the OEMs negotiated in 2007 are all transforming the industry. The new union VEBAs and related relief given to the OEMs are extraordinarily meaningful.

JOHN (JACK) WM BUTLER, JR.

Andrews: No doubt tremendous progress has been made, though not without cost. The real question is, can the restructuring of the Detroit based OEMs be completed in a timeframe that their financial capabilities can support? No one knows that for sure. All of the noise in the press leaves little doubt that the issue cannot clearly be answered. Maybe the answer is not the same for all the OEMs.

Overbeek: Clearly, car manufacturers that are facing legacy obligation issues have a competitive disadvantage compared to companies that do not. On the other hand, a stable labour market with skilled workers is the other side of the coin. Look at the problems that some Eastern European countries are facing to attract skilled workers.

In your opinion, what are the main internal operational challenges facing automotive companies?

Denkowicz: The principal internal operating challenges are meeting and exceeding governmental mandates for fuel efficiency and clean air, branding, and meeting the demands of the internet age. Alongside this, there is the continuing challenge to produce an exciting product that is desirable, reliable and more than anything else, safe.

Kelly: One more of the challenges beginning to affect the international automotive sector is the growing cost of transport. This will impact the movement of vehicles and could see an increase in some assembly operations around the world. The development of cleaner, more efficient vehicles produces a constant challenge, especially coupled with the need to produce value for money. The use of other sources of fuel to counteract the increasing cost of traditional fuels will continue to challenge the industry with water

fuelled models already in development.

Overbeek: The main internal operational challenges facing automotive companies are no doubt the increase of fuel efficiency, CO2 reduction and the search for alternative fuels or drive lines.

Chadwick: The OEMs continue to produce too many nameplates, which limits the efficiency of their capital investment. For example, GM currently has eight brands and 89 models but has struggled establishing differentiation among them. The result is lower sales volumes per model and increased engineering and capital costs per car. GM averages approximately 52,000 unit sales per model while Nissan averages 86,000 per model. Having so many brands stretches GM's engineering and design as well as its $8bn capital expenditures budget. As a result, GM's models are on sale for an average of four years before a redesign compared to three years for its Asian competitors. That makes the Asian cars fresher and more responsive to changing consumer tastes.

Savini: The change in consumer preference from SUVs and light trucks to passengers cars and crossover vehicles in North America has caught many automotive companies flat footed, the big three in particular. They've spent many years promoting and developing a production infrastructure that favours these products, which were previously profit havens. Re-tasking their product schedules and production facilities to meet the increasing demand for non-light truck product will take time and the lag will likely cost them first mover advantage in a range of evolving new product segments. If world oil prices remain at historical highs for a protracted period of time, all automotive companies will have to nimbly pivot to produce more fuel efficient vehicles with an increasing emphasis on alternative fuel products.

Andrews: The main challenge facing the Detroit based OEMs is having enough resources directed at product development for exactly the right platforms. The closer the OEM is to the edge, the nearer it needs to hit its target to remain a contender.

Butler: The challenges vary depending on where the company sits in the production chain. OEMs are working hard to produce fuel-efficient, high technology and environmentally friendly vehicles that consumers actually want to purchase. At the same time, they are well focused on and moving along the path of rationalising both their production footprint and their dealer network, reducing the number and average cost of their hourly and salaried workforce, and returning to 'core' vehicle brands while eliminating unprofitable, redundant and unnecessary brands. Tier one suppliers are continuing to transform their businesses with renewed emphasis on core technology capabilities while looking towards opportunistic global expansion. Tier two and three suppliers will face continued consolidation pressure. At every level, companies are going to face challenges in retaining and attracting highly qualified managers to the sector. Most companies are facing increased financial and operational pressures in their US based operations relating to globalisation but companies with global operations are also reaping a substantial amount of their overall profits from non-US based operations.

The main internal operational challenges facing automotive companies are no doubt the increase of fuel efficiency, CO2 reduction and the search for alternative fuels or drive lines.

WALTER VAN OVERBEEK

Are any particular regulatory developments set to alter the automotive industry?

Andrews: The most significant regulatory development in the US is the change in new corporate average fuel economy standards (CAFE) that materially increases average vehicle mileage requirements to 35 miles per gallon by 2020 – a 45 percent increase over current standards. Significant investment will need to be made to comply with this requirement – money that could be spent on styling, comfort and safety.

Gordon: CAFE standards for passenger cars and light trucks are expected to go into effect in the near future. Meeting these new standards will increase the short-term costs of production, which could impose a significant burden on financially challenged manufacturers. Without dramatically increased prices at the fuel pump, however, it is unclear whether domestic demand for more fuel-efficient vehicles will grow commensurately.

Denkowicz: The desire to address climate change, carbon emissions, and fuel efficiency is gaining ground at all levels and finally the consumer may be buying in to the need for a solution. There are signs that people are willing to abandon the hood ornament in favour of making a statement with a responsible vehicle. This movement will gain popularity and consumers may well align themselves with the industry in a direction which the government cannot alone mandate. In the end, the regulatory scheme has to be aligned with manufacturing capability and consumer demand to produce desirable vehicles.

Chadwick: The state of California has instituted very restrictive emissions standards. Recently the Environmental Protection Agency (EPA) was asked to waive federal standards and adopt California's more restrictive standards, which the EPA has at least initially declined to do. Whether or not the EPA ultimately decides to adopt California's emissions standards, there is a growing chorus demanding that the OEMs significantly modify automotive emissions. Depending on the outcome of the next presidential election, the OEMs could be faced with making this investment sooner than they had hoped. Look for the emergence of clean diesel as some of the limitations of bio-fuel supply chain come into play in the US.

Butler: There are any number of potential regulatory opportunities and challenges in the US facing the sector, ranging from environmental and emission regulations to healthcare and pension reform. Given that there will be a new President, administration and a new Congress in less than a year, both the statutory and regulatory environment is quite unsettled.

Kelly: The ever growing environmental concerns are bound to continue to affect the automotive sector, with increased regulations controlling not only emissions, but also potential efficiency. The Head of Shell raised the prospect of only fuel efficient vehicles being licensed, though the thought of an electric Bentley or Rolls Royce is difficult to imagine. Congestion charges, toll roads, etc. are bound to have an impact, but in the UK, until the investment in public transport is made, it will just be a means of raising more taxes.

Overbeek: In 2008 the players on the EU automotive market will get a better idea of what the European Commission will do after the expiry of the current competition law regulations in May 2010. The chance that the existing strict rules will be continued or toughened is small. The business is over regulated and this seems to be the current internal opinion of the European Commission as well. However, the regulatory environment with respect to CO2 emissions and safety will have an increasing and lasting influence on the automotive industry, while the 'end of life cycle' legislation is particularly important to new entrants.

Is the future likely to bring more restructurings and bankruptcies among developed market companies? Do you believe they are capable of reversing their own fortunes by making the tough but necessary operational decisions?

Savini: Given that global over capacity in the automotive industry persists and that more than one third of automotive suppliers globally are in financial distress today, it's highly likely we'll see more restructurings among developed market automotive companies, some effected through bankruptcy or alternative insolvency proceedings and some effected through workouts or out of court processes. Some of these distressed companies will be able to pull back from the brink by taking quick and decisive actions to cut overhead costs, exit non-core businesses and effect internal consolidation to optimise their capacity utilisation. Doing so will position them to become prospective consolidators instead of consolidatees as the industry shake out continues.

Chadwick: The combination of very tight credit markets and declining production volumes may portend a wave of supplier bankruptcies as liquidity dries up and sources of new liquidity become scarce. I don't think we've really felt the full impact on the retail consumers yet. None of this can be good news to the OEMs because they are increasingly being asked to share in the cost of bankruptcies through shortened trade terms, loans and pricing. In some ways it is ironic that the industry has been making the right and difficult decisions over the past several years to rationalise capacity, move production and begin to address legacy costs, but the declining sales volumes may continue to force suppliers into bankruptcy.

Andrews: There obviously will be more restructuring in the supply base and there will be more bankruptcies. There are few players that are not now making tough decisions. Given the limited room for error, there will be enough misses to ensure some degree of turmoil for a while to come. But we see relatively few failures today because people are unwilling to now make tough decisions. It's just that now is often too late. Some companies have just progressed to the point of checkmate. They are now waiting for their time to come.

Denkowicz: We are undergoing a fundamental set of changes in our world and the US economy. Already the projections for 2008 are fairly negative. If anyone knew three years ago that petrol prices would hit their current levels, no doubt automotive companies would have developed a broader array of fuel efficient vehicles as opposed to the larger and powerful vehicles that are still being introduced. More than likely, the industry will have to cope with lower unit sales for at least the next year, accompanied by a movement away from the high end heavy vehicles with the greater levels of built in profit. This will cause some dislocation on the financial statements, but it will not and should not end in bankruptcy. In the short-term, the industry is probably better suited to weather the storm than in previous years having obtained significant concessions from the unions, shut down numerous plants and reduced the employment rolls. We will, however, witness in the coming years, a change in the leadership of the industry and the type of product that is offered, at least as its mainstay.

If the developed market companies grasp the green technology, they could survive, leaving the new market companies to concentrate on introducing low cost vehicles to the rest of the world.

JOHN KELLY

Butler: Most industry observers expect that 2008 will be a very difficult year across the automotive sector. Volume reductions are likely to lead to additional supplier restructurings and bankruptcies. Major OEMs and tier one suppliers have worked very diligently to accumulate cash reserves or tap additional sources of debt or equity capital in order to maintain adequate liquidity in the short term to weather the current difficult environment. The principal basis for optimism about the future of the sector is that is real evidence that both management and labour leadership recognise the challenges facing the industry and are prepared to continue to make difficult operational decisions to continue to transform the US automotive sector. There has been enormous change across the industry over the last few years that will need to continue to occur and even accelerate in order for US based businesses to compete successfully in the global economy.

Kelly: In developed markets, we are bound to see more fuel efficient and environmentally friendly vehicles. In the underdeveloped countries, we will see a significant increase in car ownership with the likes of Tata producing low cost cars to encourage their use and development. If the developed market companies grasp the green technology, they could survive, leaving the new market companies to concentrate on introducing low cost vehicles to the rest of the world. ■

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