booz&co.

2012 Automotive Industry Perspective

2012 AUTOMOTIVE INDUSTRY PERSPECTIVE

We would like to offer our thoughts on the current business environment for automobile manufacturers and suppliers, what the future might hold, and the capabilities that can position your enterprise for sustained success.

Where We Stand

For U.S. automakers and suppliers, the past year can best be described as 12 months of mixed results, leaving unanswered questions about the future direction of the industry and what is required for manufacturers and suppliers to thrive.

In 2011, U.S. light car and truck sales will exceed 12.5 million, a nice bump from 11.6 million in 2010 and 10.4 million in 2009. And though the most optimistic analysts forecast that U.S. vehicle sales will rise to more than 14 million in 2012, that's a far cry from 17.3 million at the turn of the millennium. Last year's U.S. sales figures might have been higher if not for the tsunami and earthquake in Japan and flooding in Thailand, which forced Toyota, Honda, and, to a lesser extent, Nissan to curtail production in virtually all of their assembly plants around the world. Auto sales growth is far more rapid in emerging nations such as China and India, with average annual sales gains since 2001 of 23 percent and 15 percent respectively.

All of this should be good news for U.S. automakers, which have restructured their operations to be profitable at lower volumes in the U.S. General Motors, Ford, and Chrysler gained market share at the expense of the Japanese manufacturers, and the Detroit Three have now posted several quarters of consistently strong operating performance. Whether these improved earnings are short-lived will depend on a number of unknowns:

- As their output returns to normal, will Japanese companies reclaim their market share?
- Will the Detroit Three maintain their focus on new vehicle development and launches and continue to practice pricing discipline, which favors maximizing profits over volume or marketshare growth?
- How will rapid introductions to the U.S. market of highly competitive new models from automakers around the globe, combined with slow growth, play out? How will automakers differentiate their vehicles and earn the pricing and volume they need? What will they do to ensure that each program delivers an attractive return on invested capital?
- How will automakers serving the U.S. market protect themselves against the risk of disruption (such as the supply chain disruptions we have seen in Japan and Thailand) and will they do it at an affordable cost?

Automakers will also face technological challenges. For example, advances in braking, parking assistance, propulsion, sensors, and other critical areas are bringing us closer and closer to the era of self-driving automobiles; indeed, Google has already logged well over 100,000 miles on its unmanned robotic vehicle. In urban areas, in particular, these innovations could improve traffic flow, provide revenues (through "smart tags" and traffic congestion pricing), and reduce accidents through vehicle-to-vehicle communication and coordination.

Meanwhile, vehicle-based mobile communications technology continues to produce breakthroughs in voice-activated telephony, GPS, information, and entertainment. For example, GM customers can now use the automaker's OnStar (driver communication) and RelayRides (vehicle location tracking) systems to rent their personal vehicles to others and charge fees based on usage. Both original equipment manufacturers (OEMs) and suppliers will have to anticipate which new technologies and add-on services will justify the cost of innovation. Clearly, anything that consumers are willing to pay for, that increases safety or functionality, or that reduces cost has the potential to be successful. At the same time, OEMs must be careful to integrate new technology into vehicles effectively and only when it is well perfected, or risk adding features that are annoying or, worse yet, prone to breaking down, which could negatively affect consumer perceptions about the quality of the automaker's products.

A return to competition based on innovation is a refreshing change from the dismal situation the industry faced just two years ago. And while the Detroit Three focus on producing more exciting and attractive vehicles, they can take comfort in having addressed a perennially problematic issue through a new and mutually beneficial four-year labor agreement with the United Auto Workers. By being able to pay newly hired workers at rates comparable to those paid by Asian transplants in the U.S., GM, Ford, and Chrysler have taken another important step in narrowing the gap with their rivals on manufacturing costs.

Suppliers are also relatively well positioned after several difficult years. Many suppliers were very profitable in 2011; they have emerged from the recession (and, in many cases, Chapter 11) with restructured balance sheets and lowered breakeven points. Moreover, supplier relationships with GM, Ford, and Chrysler have improved, according to the annual Planning Perspectives OEM–Supplier Working Relations Index. But there is more work to do: Chrysler and GM still score in the "very poor–poor" range.

There are some dark clouds for suppliers, though. Raw material prices, already elevated, may continue to rise, and many suppliers are struggling to find the capital to ramp up production to meet increasing demand. Moreover, most suppliers must continue to deal with what has become an endemic issue: a talent shortage, as top-flight engineers willing to work in the auto industry are increasingly hard to find.

A Capabilities Strategy for OEMs

Against this backdrop of an industry still in flux, this is the perfect moment for OEMs and suppliers alike to invest in developing the capabilities that allow them to achieve and sustain a leading position around the world. We define capabilities as the distinctive strengths a company has, or should develop, to set it apart from competitors. Each capability is built on a combination of processes, tools, knowledge, skills, human capital, and organization.

Prepare for Black Swans

There is a natural tendency following horrific events such as the Japanese tsunami to evaluate a full range of risks and prepare contingency plans. But most black swans are the result of a cascading series of events; it is the cumulative impact that makes them so catastrophic. It is not justifiable to build costly, fully redundant supply chains, when the chances of another complete meltdown disruption are fairly small. Companies would be better off by developing a risk preparation capability: Analyze the impact of potential disruptions and prioritize responses by magnitude and chance of exposure, expense, and ease of implementation. For example, manufacturing key electronic components in one location may yield attractive economies of scale but also significant risk. Options to mitigate the risk include splitting global volume across at least two facilities in different regions, or maintaining centralized production with backup capacity, possibly with a different supplier that can be brought up quickly. Recent experience has proven that having transparency and visibility several layers deep in the supply chain—that is, controlling and managing activities and risk among a supplier's suppliers and their suppliers—is very difficult and yet essential. Therefore, automakers must do their best to protect themselves with nimble, agile response mechanisms, systems, and processes. (*For an in-depth examination of this topic, see "Are You Ready for a Black Swan?".*)

Build an Adaptive Innovation Engine

In mature markets such as the U.S. and Europe, success depends on bringing to market ever-evolving new vehicles that consumers enthusiastically want and would be proud to drive. But the best ways to do this are rarely clear. For example, powertrain technologies are evolving rapidly; most manufacturers are thus trying to manage balanced portfolios of internal combustion, hybrid, electric, and fuel cells until there is greater clarity about the future. The challenge is exacerbated by fluctuating fuel prices and inconsistent government policies that make setting a long-term course and sticking to it extremely difficult and costly. Therefore, manufacturers need to develop distinctive practices—which might include open networks, frugal engineering, more intensive partnerships with suppliers, or other refinements—to out-innovate the competition at an affordable cost.

Operate in a Global Marketplace

Emerging economies such as the BRIC nations (Brazil, Russia, India, and China) offer the potential for high growth and an opportunities to build strong positions in the biggest consumer markets of the future. By contrast, North America and Europe have high volumes but much more limited growth potential. Given this divide, OEMs need to tailor and customize their product portfolios to meet the disparate requirements of both mature and emerging markets, which have fundamentally different consumer needs and preferences, competitive dynamics, and economic returns. For example, manufacturing strategies for emerging markets should evolve over time, with long-term investment horizons and factories producing less expensive, less profitable automobiles now but geared for assembling higher-priced, higher-return vehicles in the future.

Manage Inventory Well

In a highly competitive market, it is more critical than ever for automakers to provide a mix of models and trims on dealer lots closely matching customer demand, although given the permutation of vehicles necessary to meet distinct customer needs, 100 percent inventory coverage is neither possible nor practical. Providing the right inventory means at a minimum continually improving distribution and sales forecasting capabilities to make sure inventory in each region is adequate, but not excessive, based on potential sales. More ambitiously, smart inventory strategies may involve transitioning to a more sophisticated mix of build-to-stock for popular combinations and build-to-order, with more rapid and certain delivery than today, for unusual combinations. This could generate significant cost savings and better align vehicles with customer preferences.

Maintain Pricing Discipline

Capacity issues have essentially been addressed in the U.S.; factory utilization rates are quite high for most OEMs in the NAFTA region. High-capacity utilization brings less pressure to offer discounts and incentives, and OEMs have taken excellent advantage of this situation to enjoy higher realized prices and profits. But as competition increases, automakers must maintain this rigorous and dispassionate approach to pricing and incentives, using advanced modeling to understand price–volume trade-offs and to estimate residual value effects of first-transaction decisions. And they must be willing to prioritize medium- and long-term profitability over immediate market share.

Focus on Customer Experience

As vehicle and quality differences narrow, automakers are increasingly exploring ways to create differentiated experiences for customers throughout the vehicle life cycle. This is fertile territory for revenue and earnings growth but requires a well-defined OEM capability. You must define the experience you want to provide, make it consistent with your brand heritage, and make every aspect of your product and service ecosystem more customer-centric—including in-store experience, warranty and ongoing maintenance and repair, and financial services options and execution. Over the past decade, there have been numerous attempts at this, often with high expectations; most have fallen short. We believe that in an era when consumers seek value, OEMs that can master and execute this capability best will gain a major competitive advantage.

Primary Capabilities for Suppliers

Drive Innovation

One excellent way for suppliers to capture value is to offer OEMs something that others don't and can't. Indeed, when suppliers create end-user pull around their intellectual property, they can build market share and earn high profits. For example, one company has held a very large share of the global market for auto-dimming mirrors for years, with exceptionally high profits for a Tier 1 supplier as a result. In other cases, process and supply chain innovation can drive durable cost advantages, even for products that are commodities or close to it. Successful suppliers must understand the opportunities for innovation of both types to create and capture value, and invest accordingly.

Refine the Factory Footprint

The economics of manufacturing in low-cost countries are shifting. With Chinese wages on the rise and an artificially strong renminbi, the tide of production shifting to Asia has slowed. In fact, for some products that do not ship well or have relatively low labor content, regional production footprints—factories in Asia, North America, Europe, and South America, for example—are increasingly preferable. The question to ask is what factory network will allow you to meet forecasted demand for your products most cost-effectively—and more cheaply than the competition.

Ruthlessly Manage the Portfolio

All too often, suppliers try to be everything to everyone—and, in doing so, design products that fail to meet the needs of anyone. To avoid this trap, suppliers must develop the market insight necessary to understand fully the varied requirements and purchase decisions of different OEMs and different market segments. With this knowledge, suppliers can determine which segments are most attractive based on their core skills, strategic outlook, and business and operating models. This prioritization allows suppliers to target resources to business units with the potential to create sustainable and strong market positions and stop subsidizing weak businesses with little or no strategic value. Suppliers with this sophisticated knowledge of their businesses also know when to walk away from bids and programs when the economics are not right—pursuing programs with poor economics to fill factory capacity in hopes of someday increasing prices and margins is chasing after fool's gold.

Leverage M&A Potential
Large M&A deals have been rare among auto suppliers during the post-recession restructuring period, but the pace of consolidation will pick up during 2012 as private equity and strategic buyers return to the market. In fact, a Booz & Company survey of automotive executives earlier this year (*see "Is the U.S. Auto Industry Ready for Economic Recovery?"*) found that 60 percent of automotive suppliers are actively pursuing acquisitions. Suppliers must assess their positions in this context—are you a buyer or a seller?—and in turn work to build the necessary supporting capabilities. For example, if you are a buyer, how do you assess which targets are the most attractive to your organization, and how do you overcome the operational, customer, financial, and change management challenges to ensure that you are able to capture the full value of an acquisition? And if you are a seller, how can you secure the most attractive valuation for your company?

Preparing for a Time of Transition

We hope that this letter stimulates your thinking about the capabilities your organization should develop or strengthen to compete in this unsettled but potentially very rewarding period for the auto industry. We welcome the opportunity to hear your thoughts about the year ahead and discuss how you might create a more prosperous 2012.

Booz & Company is a leading global management consulting firm, helping the world's top businesses, governments, and organizations. Our founder, Edwin Booz, defined the profession when he established the first management consulting firm in 1914.

Today, with more than 3,300 people in 60 offices around the world, we bring foresight and knowledge, deep functional expertise, and a practical approach to building capabilities and delivering real impact. We work closely with our clients to create and deliver essential advantage. The independent White Space report ranked Booz & Company #1 among consulting firms for "the best thought leadership" in 2011.

For our management magazine *strategy+business*, visit strategy-business.com.

Visit booz.com to learn more about Booz & Company.

Contact Information

Scott Corwin
Partner
scott.corwin@booz.com

Evan Hirsh
Partner
evan.hirsh@booz.com

Jan Miecznikowski
Partner
jan.miecznikowski@booz.com

Brian Collie
Partner
brian.collie@booz.com

Mike Beck
Senior Executive Advisor
michael.beck@booz.com

The authors wish to thank Booz & Company senior associate Patrick Mulcahy for his contribution to the research and thinking in this letter.