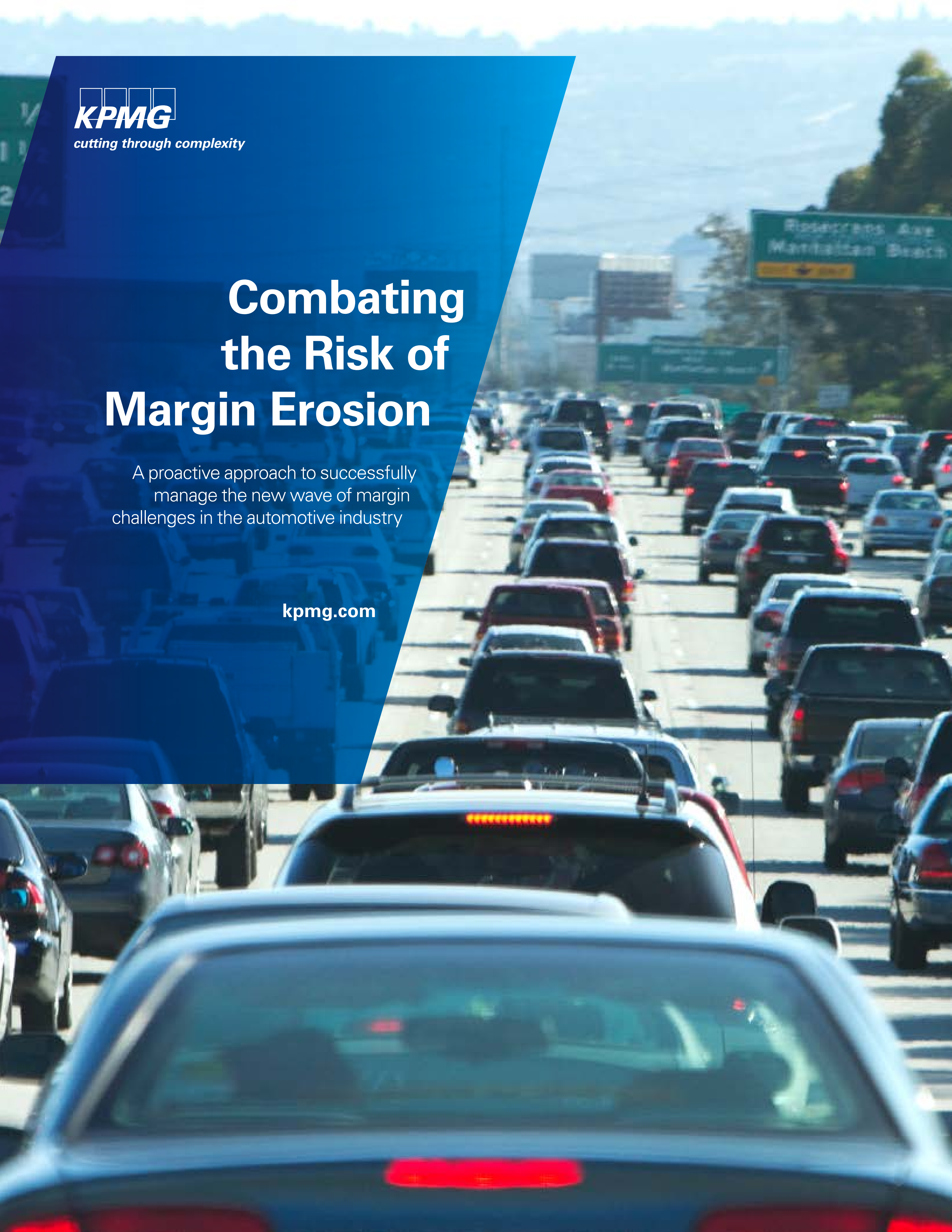

KPMG
cutting through complexity

Combating the Risk of Margin Erosion

A proactive approach to successfully manage the new wave of margin challenges in the automotive industry

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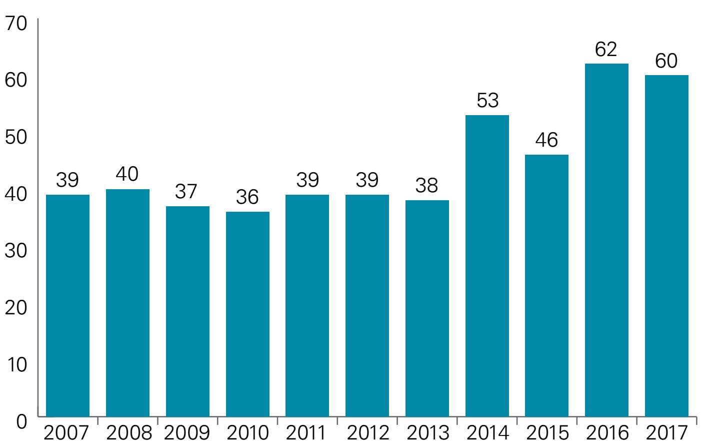
After recovering from the devastating depression that hit automakers in 2008, manufacturers and suppliers can now confidently say they are in an up cycle. Distress and crises are now less frequent, however there may be an unrealistic sense of security that could leave manufacturers and suppliers alike unprepared to face ongoing challenges throughout the automotive supply chain. The list below, while not exhaustive, contains certain key areas that should be proactively addressed by manufacturers and suppliers in order to successfully navigate the new wave of financial, operational, and strategic challenges:

- Launch costs and capacity utilization
- Shorter automobile product life cycles
- Lack of talent and pressure on wages
- Rise of health care costs, regulatory compliance, and government mandates
- Rise of interest rate environment as debt becomes due for refinancing
- Increased quality, warranty, and recall costs
- Private equity dynamic

Launch Costs and Capacity Utilization

There are a record number of vehicle launches scheduled in North America between 2015 and 2017. According to LMC Automotive data, there are approximately 170 new launches announced for that three year period, which comes on the heels of a very active twelve months in 2014.

North American new model launches



Source: LMC Automotive

While the anticipated volume growth can provide substantial opportunities, these vehicle launches stress suppliers' manufacturing processes as well as create a financial burden in up-front costs that are generally not recovered until the new products are placed into production. Successfully meeting the milestones associated with new vehicle launches is key, but at what cost? A record number of launches could mean record levels of costs for OEMs and suppliers if these new launches are not proactively and aggressively managed.

Due to this volume growth, capacity utilization is currently at an all-time high of 80 percent, according to the U.S. Federal Reserve Board of Governors. This leaves little time for suppliers to focus on lean, preventative maintenance, and continuous improvement efforts. Additionally, suppliers are considering new investments and re-instituting postponed investments despite a continued reluctance to increase fixed costs.

Shorter Automobile Product Lifecycles

The increased launches largely result from the competitive automotive market that is driving automotive manufacturers to significantly redesign or refresh car models more rapidly, thus shortening the automotive product lifecycles.

Suppliers typically earn higher profits in the later years of a vehicle model, after recovering from launch and equipment start-up costs. However, the demand for innovation from today's market has compressed the product lifecycle to as short as four years. Therefore, it is critical for OEMs and suppliers to closely monitor the overall costs of production and investment, while also maintaining flexibility to manage the ever-increasing complexity. Maintaining flexibility with global platforms and reducing redundancy of part production has proven to be no easy task, but is expected to be crucial to sustaining margin and return on investment.

Lack of Talent and Pressure on Wages

Looking back to before the rise of launches and shorter product lifecycles, automotive companies eliminated close to half a million jobs as part of the cost cutting initiatives to survive the 2008 recession. As a result, many highly skilled/highly experienced people migrated to other industries and are not expected to return. Suppliers and manufacturers may need to incur recruiting costs and higher wages to lure the required talent back to the automotive industry. The lack of human capital is extremely prevalent at the Tier II and below level as many of these critical, technical employees have moved up to the Tier 1 and OEM level. This is forcing suppliers to become more aggressive with strategies and methods to attract and retain talent, further increasing fixed costs.

Additionally, organized labor conceded to concessions in wages and benefits while the industry was in crisis. Now that manufacturers and suppliers are profitable, workers will be seeking to share in the financial success. The 2015 contract talks will be the first opportunity for union workers at GM and FCA to threaten to strike, a right that was compromised as a condition of the government bailouts. Already talks for OEMs and Tier I suppliers to eliminate the two-tier wage system have begun, which only increases cost without any promise of increased productivity; a change that will impact suppliers with both union and non-union employees.

Rising Health Care Costs, Regulatory Compliance, and Government Mandates

While the shortage of talent is significant, the rising costs of

providing health coverage to employees is also a challenging area in managing margins. According to KPMG's 2014 CEO Survey *"Setting the Course for Growth,"* health care costs and reform are viewed as top issues among executives. The rising cost trajectory, the 40 percent excise tax expected to take effect in 2018, and other plan design changes have many employers concerned. Lower tier suppliers will be impacted in 2015, as businesses with 100+ full time workers must provide health insurance or pay a monetary fine. In 2016, this number reduces to 50+ employees for the ability to levy a fine. For businesses large or small, health care costs are an ever-increasing employee related cost that must be continuously managed for innovative solutions.

Government regulations designed to increase fuel efficiency (CAFE) and reduce emissions are adding cost across the product lifecycle for auto manufacturers. In order to meet such requirements, automakers are forced to explore new designs, materials, systems, and processes; with the associated cost and development burden potentially being passed onto the suppliers. Both OEMs and suppliers should take a strategic approach to effectively manage the costs associated with the tightened regulations.

Other select regulatory challenges include:

- Conflict minerals (Dodd Frank) – A lack of supply may increase the market price of essential minerals and efforts to remain compliant with this act can add further costs.
- Antitrust litigation – Multiple antitrust cases against cartels in the auto parts industry ($2.4B in fines imposed through September 2014).
- Safety recalls – Oversight of safety related recalls increases cost in the supply base.

Rising Interest Rate Environment as Debt Becomes Due for Refinancing

A low interest rate environment has enabled many companies to refinance and further delay debt maturities, thus reducing refinancing risk for the next couple years. As a result, a daunting debt maturity cliff has emerged, as a significant amount of loans are coming due in 2017-2018.

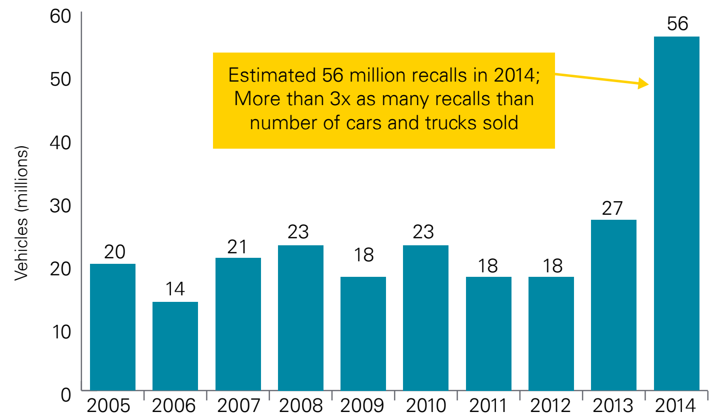
> *"The amount of company loans set to mature in 2017 and 2018 has increased by 50 percent to $890 billion over the past 12 months as issuers refinanced debt at a record pace, according to Fitch Ratings" (Bloomberg, 2014).*

The same companies that benefited from the low rates now face potential increased cost of capital, as interest rates are expected to begin to rise as early as the third quarter of 2015. Additionally, the ongoing structural changes to the automotive industry may make it more difficult for companies to address their debt maturities, as the ability to finance new manufacturing technologies or increased capacity is expected to carry a higher price tag. As companies are unable to refinance due to the possibility of economic or industry changes, distressed-debt exchanges or bankruptcies may become more frequent options.

Quality, Warranty, and Recall Costs

While preparing for future economic distress, competition and scrutiny also has automakers focusing harder on increasing their standards for quality performance. In doing so, the metrics and methodologies used to measure quality and warranty performance continue to be refined and redeveloped, placing further burden and pressure on the supply base.

10 year warranty recall trend



Source: National Highway Traffic Safety Administration

Increased Government oversight following recent severe safety recall issues has contributed to an estimated 56 million recalled vehicles in 2014 (more than three times the number of cars and trucks sold). These high-volume recalls impacted relatively fundamental parts, however the potential for new, more complex recall issues and continued rising warranty costs exist as cars become more technologically advanced. As recall costs grow, automakers may look to pass such costs along to the source suppliers, thus further straining OEM-supplier relationships and reducing profitability.

The focus on quality throughout the supply chain is paramount, and robust quality systems, processes, and performance should not only exist but continue to be improved upon to keep pace with the industry's shifts in technology and production expectations. But simply having these systems and processes in place is not enough as the key is to use the resulting data proactively in order to effectively manage supply risk and operational issues. This can present challenges for the lower tier suppliers as they might not have the experience, systems, or resources to do so.

Private Equity Dynamic

It is critical for OEMs and suppliers to know how many of their suppliers are owned by Private Equity (PE) firms. The answer to this question, as the strategic focus and investment cycles of PE may differ from OEMs, could cause a potential disruption in current production and vehicle development cycles. We have seen recent PE exits from distressed automotive supplier situations result in costly scenarios:

- Customers may be leveraged with pricing or other accommodations in order to enable PE to achieve the targeted return to allow for an exit.
- PE may no longer be willing to invest capital or resources into the portfolio company, which may result in margin erosion and other related financial or operational issues.

We are already partnering with leading companies to bring a heightened and more comprehensive awareness of where PE firms exist and/or strategically fit in the supply base which may help reduce risk and prevent these costly scenarios for both OEMs and suppliers.

Challenges Bring Opportunity

We are seeing head winds that are expected to challenge profitability of the supply base in the near-term if aggressive actions are not taken now to actively manage costs, risks and continuous improvement activities. It is paramount for both suppliers and their customers to understand the impact these rising costs are expected to have on the viability of the supply base. With the compression of the supply base that has occurred over the last decade, there are many sectors and commodities in the auto industry that cannot afford additional loss of suppliers.

Therefore, in these current times of high volumes, it is critical for the OEMs and Tier 1 Suppliers to focus on ensuring that both they and their extended supply base are maximizing profits. Increasing efficiencies and cost and risk management practices should be implemented to ensure ongoing viability and to provide protection from the impacts of the next economic cycle. Given what we know about the cyclical nature of the auto industry, and the fact that we are six years into a boom cycle, some level of downward trend should not be unexpected. OEMs, Tier 1 Suppliers, and the rest of the supply base need to diligently focus on profitability and proactive measures to ensure that history is not recreated. Now is the time to prepare, and KPMG is uniquely positioned with a dedicated group of individuals that can help your business strategically plan and adapt to the financial, operational, and strategic challenges presented by this complex industry. We provide tangible results to our clients

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