KPMG

Capturing value in automotive M&A

Automotive demand has rebounded and M&A activity in the industry is revving up again, too. As in prior recoveries, there will be a range of deals—consolidations, restructurings, carve-outs and growth plays. But now automakers and parts suppliers are also making deals to position themselves for a changing industry, with high-tech electric, connected and autonomous vehicles. These high-stakes deals are bets on the future. As our research shows, many automotive deals fail to deliver expected value because of poor execution. But acquirers that plan integrations carefully, avoid common pitfalls—and execute well—can make their deals pay.

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Introduction

With the U.S. economy shaking COVID-19, the automotive M&A market is rebounding. Players are looking for growth, to consolidate, and to position themselves for a changing industry. As companies get ready to compete in electric vehicles, for example, they are making massive investments in new capabilities and reviewing their portfolios of businesses to see what fits and what doesn't in the future automotive business. (For more on this transition, see *Place your billion-dollar bets wisely: Powertrain strategies for the post-ICE automotive industry.*)

This portfolio rebalancing will result in a range of actions from transformative M&A and divestitures to wholesale shifts in internal capital allocation to more "creative" partnership structures to access new technologies. In particular, CEOs may increasingly see divestitures as a way to focus on and fund a redefined core business.

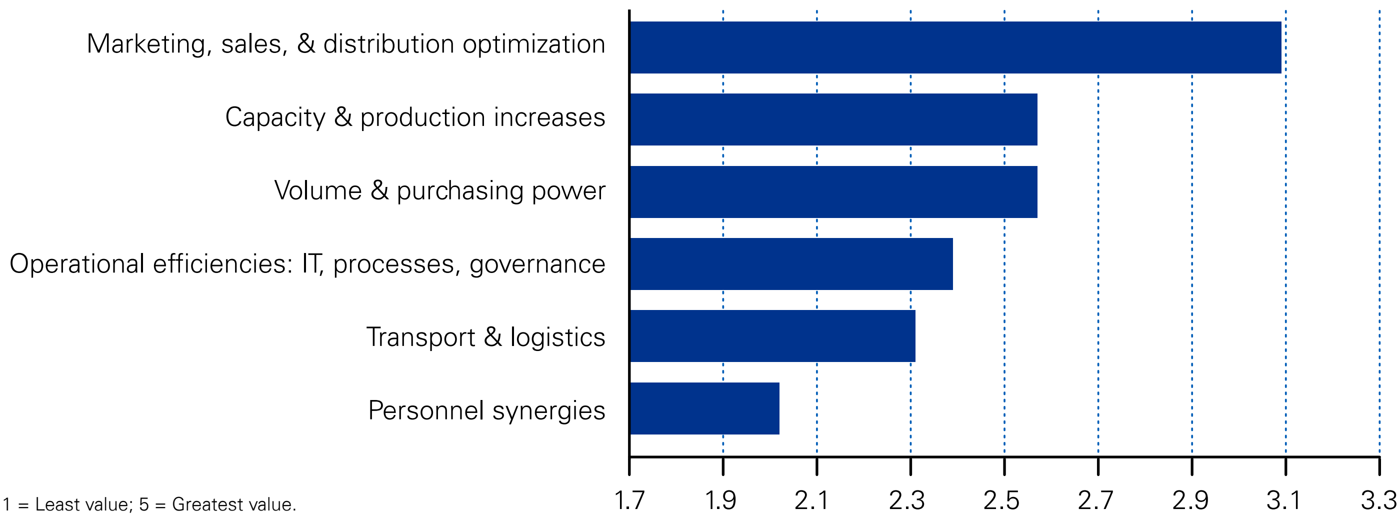
Meanwhile, the boom in SPACs (special-purpose acquisition companies) has reached the automotive sector. SPAC acquirers have been investing in battery technology, lidar, autonomous vehicles, etc. This new competition raises the stakes for automakers and Tier 1 parts suppliers.

What has not changed is execution risk, especially during integration. Nearly 65 percent of executives who participated in our 2021 automotive industry survey cited poor execution and organizational disruption as the key contributors to value destruction in automotive M&A. In this paper, we share with C-suite executives and strategic planners our findings on the causes of execution failure and the ways to avoid them.

Value creators

Where do automotive companies seek to capture the greatest value in M&A? According to industry executives, the leading contributor to value comes from optimizing marketing, sales and distribution (Exhibit 1). Increases in capacity and production, and improvements in volume and purchasing power also have high potential for value creation. Supply chain optimization and personnel synergies, however, were cited as far less important to value realization in automotive M&A.

Exhibit 1. Where dealmakers capture value in automotive M&A



1 = Least value; 5 = Greatest value.

Marketing/sales/distribution optimization

One of the most common integration tactics for revenue improvement is cross-selling, such as increasing content per vehicle (CPV) through cross-selling on core vehicle platforms. Cross-selling can be especially accretive when the buyer and target have complementary or adjacent product lines. It can also be accretive with non-complementary product lines; for example, when the buyer's customers are already purchasing the target's products from a competitor, they can now be steered toward the target's products. To plan for cross-selling, begin with an analysis of customer overlap—looking at clients, programs and commodity. Savvy executives will weigh these three elements to realign sales teams, and their incentives, to go after the greatest areas of opportunity in the combined customer base.

Methods for improving margins vary depending on the assets acquired and the market. Key factors include the location of plants, overlap in shipping routes and potential to source lower-cost materials. Lowering the cost of goods sold to improve margin can take different forms depending on the environment. When material costs are high, see if a newly acquired plant may be able to produce an input for a plant in the buyer's network at a lower cost. Such opportunities for lowering input cost are especially effective when replacing a plant input from an external supplier, thanks to higher network utilization.

Capacity/production increases

Considerable returns are possible when a buyer acquires products that can be produced and distributed through its own operations. This is true even when the buyer's production network is highly utilized; in such a case, the target's network may serve as an attractive means for expanding production. Both scenarios, however, are most effective in markets where demand exceeds supply, or where imminent growth looks likely. Understanding the cost curve for the combined plants is a critical input to footprint consolidation plans.

Purchasing power

Our experience and research confirm that combined volume and purchasing power can generate great value. But to maximize value, detailed planning in inventorying, categorizing and prioritizing direct and indirect contracts based on expected returns and their timing is necessary.

While an analysis of best prices may be the easiest exercise, strategic sourcing should be the broader long-term goal. Rationalizing the specs across the buyer and target's networks is key to harmonizing categories and strengthening negotiations. Then, review supplier terms and conditions to optimize working capital. Terms such as liability and indemnification on returns and chargebacks, for example, may create leakage and are an essential piece of the framework for consideration beyond payment terms.

For direct contracts, companies should take into account not only savings from combining contracts for common suppliers, but also consider more qualitative factors such as their reliability, proximity and ability to fulfill.

Operating efficiencies

Our experience in integration shows that a lack of focus on combining people, processes and systems often proves to be the culprit when companies fail to realize efficiencies in corporate back-office functions such as IT and transactional finance. But simplifying the support infrastructure in processes and systems provides a better platform for future tuck-ins, bolt-ons or full-fledged integrations. Transformative steps include ERP integration, data center consolidation, moving to cloud-based services, and establishing or expanding shared services.

For IT, visibility into spending is critical. In automotive IT, definitions vary on what qualifies as technology spending, which results in an inability to define and capture relevant saving opportunities. Companies will often find potential savings simply by establishing a single view of technology spending across the buyer and target.

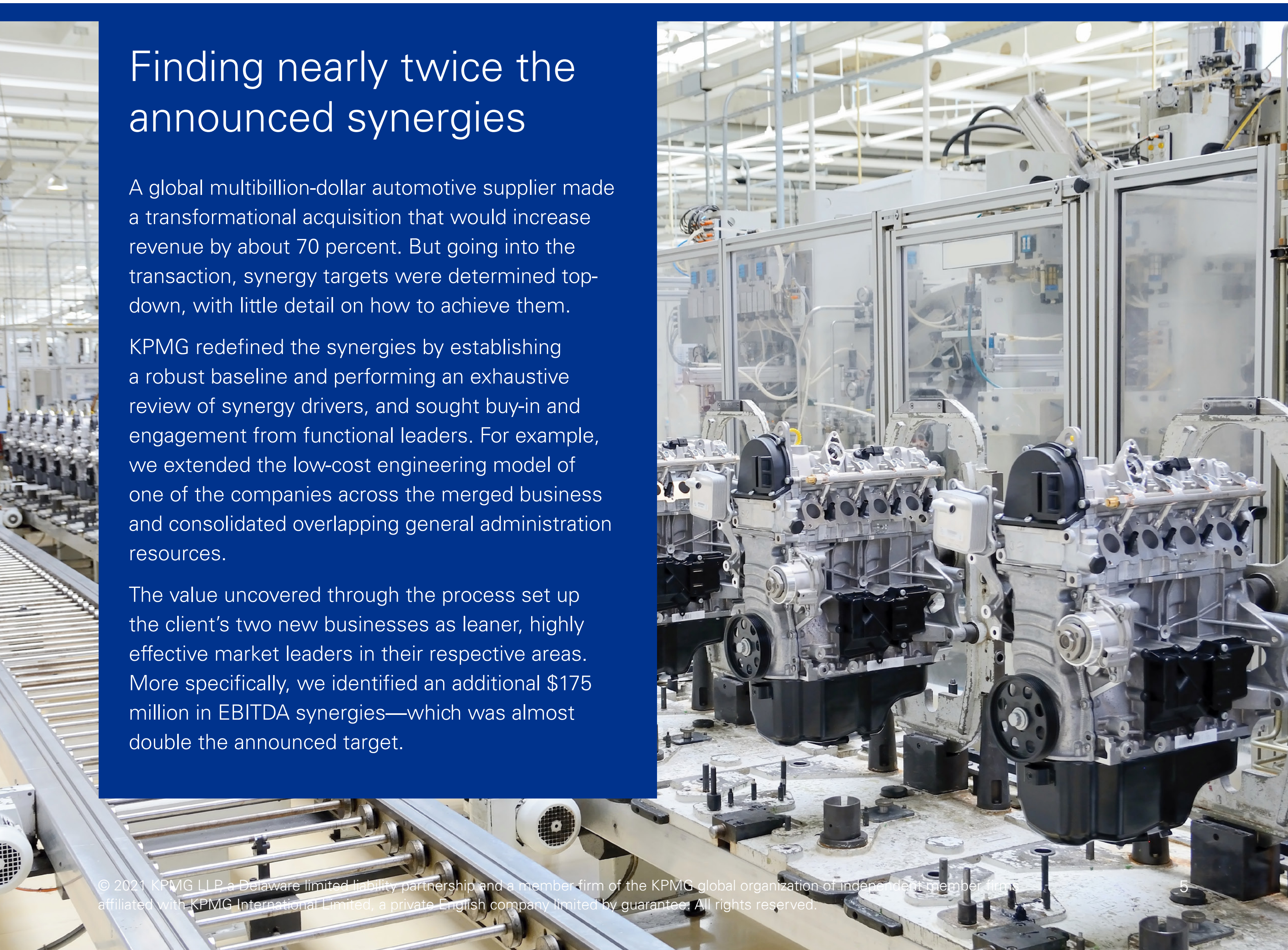
Transport and logistics

Combining two similar automotive companies usually yields opportunities to optimize freight suppliers, routes, fleet size/complexity, and supplier locations. In addition, advantages either of the two companies have in supply chain management technology can be scaled up to create value.

Personnel synergies

Personnel synergies are attractive due to how fast they flow to the bottom line, although consideration to the method of analysis, selection and communication are paramount to the success of the future organization. Key to these is communication—transparency, candor and timing are critical to successful personnel synergy campaigns. It creates dignity for the employees.

For the talent to be retained, be sure to build promotion plan and be clear about any expected changes in behavior. The talent selection process needs to be based on a view of individual and group capabilities rather than a brute-force, role-to-role redundancy approach. Success is based on the broader capability for a given function and its capacity, from a current state and forward-looking basis.



Finding nearly twice the announced synergies

A global multibillion-dollar automotive supplier made a transformational acquisition that would increase revenue by about 70 percent. But going into the transaction, synergy targets were determined top-down, with little detail on how to achieve them.

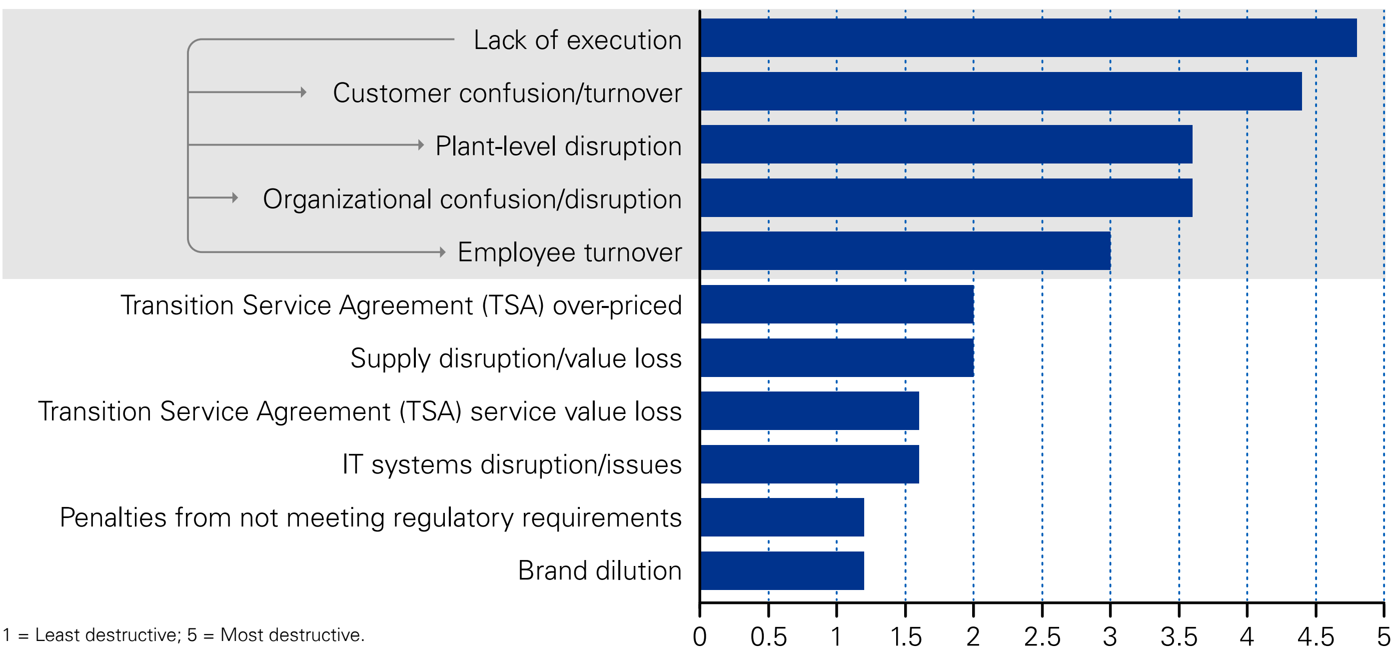
KPMG redefined the synergies by establishing a robust baseline and performing an exhaustive review of synergy drivers, and sought buy-in and engagement from functional leaders. For example, we extended the low-cost engineering model of one of the companies across the merged business and consolidated overlapping general administration resources.

The value uncovered through the process set up the client's two new businesses as leaner, highly effective market leaders in their respective areas. More specifically, we identified an additional $175 million in EBITDA synergies—which was almost double the announced target.

Value destroyers

The No. 1 value destroyer in automotive deals is poor execution, according to our survey. Poor execution leads to the four biggest items on any buyer's unwanted list: customer defections, plant disruption, organizational confusion and employee turnover (Exhibit 2). Indeed, in our experience, companies that wind up in distress or in need of a turnaround wound up in these situations due to lack of execution.

Exhibit 2. Top sources of value destruction in automotive M&A



1 = Least destructive; 5 = Most destructive.

Customer confusion

While optimization of marketing/sales/distribution ranked as the driver of greatest value, it is also one of the riskiest areas to successfully integrate. To minimize confusion and reduce the risk of customer losses, companies should plan for minimal change in customer-facing activities in the first 30 days. They should consider deferring these initiatives through phased steps culminating in a "customer" Day 1, when the most sensitive changes start to become effective. This allows time to stabilize relationships with key accounts and to better prepare changes that will affect the customer experience, such as changes in payment terms.

Some of the most common disruptions to customers in an integration include changes to payment terms and contractual agreements, and changing customer contacts due to organizational realignment—combining and resizing the sales staff or reallocating accounts.

Plant-level disruption

Often, acquirers simply seek quick synergies at the plant level, such as headcount reductions, which can lead to disruption. Integration provides the opportunity to standardize the key performance metrics for the combined company—defining what to measure, how to measure it, how to report and how often. While providing the target's plants with a set of parameters that define the acquirer's "company way," the target's standards and methods should also be taken into account with a view to reverse-fitting any areas where the target is significantly stronger.

A successful plant integration starts with the help of senior managers with on-the-ground knowledge of day-to-day operations. This can serve as a reality check for top-down targets and integration plans drafted in early stages of the deal.

Organizational confusion and disruption

Between front-office, back-office and operations, there will be many projects, activities, deadlines, people and assets to keep in alignment. A clear command-and-control structure tied to value-producing workstreams is a must to reduce disruption. And senior management supported by teams from both the buyer and target should lead these workstreams to ensure that the best ideas and feedback are incorporated into integration plans. From a communication standpoint, a structured framework to inform, explain, engage and connect everyone to minimize confusion is essential.

Employee turnover

It is impossible to keep employees who are determined to leave. To minimize the damage, it is critical to identify both high performers and high-potential employees and outline a plan for their careers in the organization. One of the most common causes for turnover at the management level and in the corporate front and back offices is lack of clarity in reporting lines and concerns over career growth post-transaction.

At the plant level, employee turnover is often tied to changes in shifts, hours, pay cycles and benefits.

Don't wait to get a handle on the situation—monitor the behaviors that are associated with turnover (e.g. unplanned leave, negative social media activity, tardiness, increase in violations, etc.). Then take steps to address the underlying causes. Organizations should perform a culture assessment prior to close to identify and address employee concerns, then distribute a robust FAQ to address common concerns (e.g. benefits changes), and clarify interim and future reporting lines.

Ensuring stability from Day 1

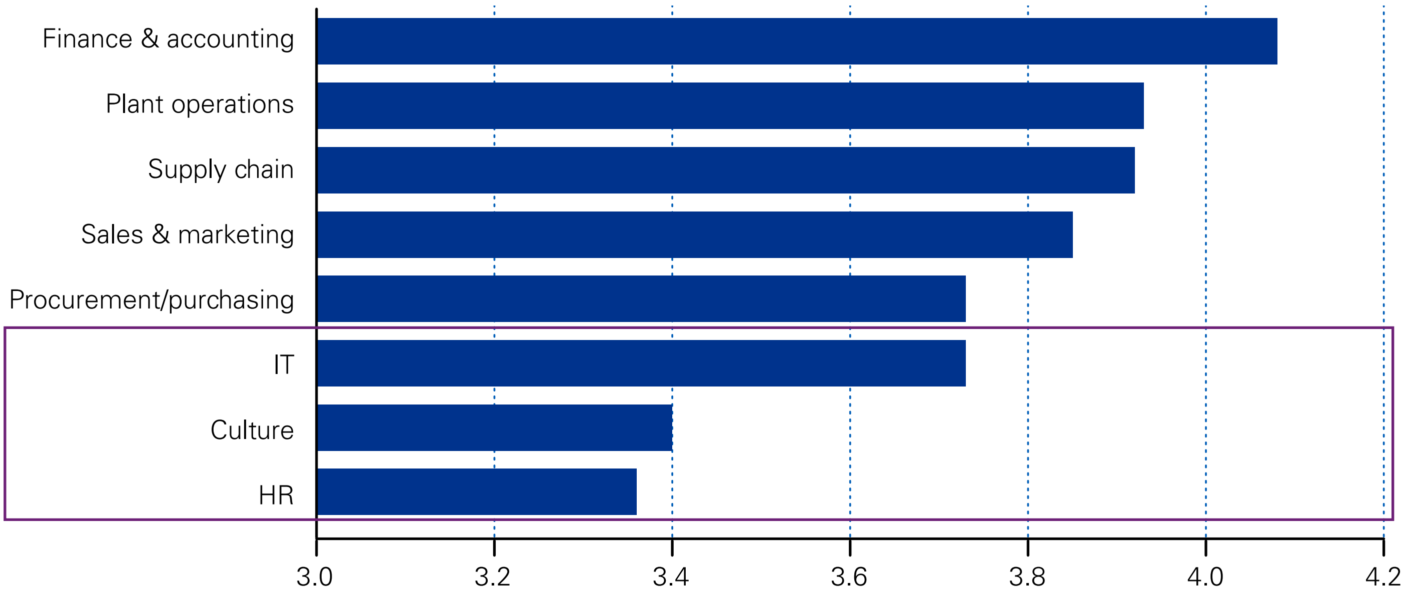
At the onset of COVID-19, a leading automotive parts supplier was planning the largest acquisition in its history, a $3.3 billion deal to buy a leading maker of electric propulsion components. Working with the buyer's senior leadership, KPMG helped create an integration plan to avoid disruption by focusing first on HR and IT. To maintain a positive employee experience, the HR team created an employee engagement platform with geographically customized deal-related information. The IT team supported the effort with collaboration tools (i.e. instant messaging, file sharing, email, etc.) that would be accessible from Day 1.

When the restructuring began, there was no analysis of headcount synergies, making it difficult to track progress toward synergy goals. KPMG developed a dashboard summarizing value capture from headcount actions. Also, due to the target's organizational structure and cost allocations, there was no clear view of the IT budget. We helped the company develop a joint company IT budget, resulting in about $35 million in IT run-rate synergies. In total, the buyer was able to pursue $175 million in synergies.

Three trouble spots to focus on

The hardest functions to integrate according to our survey are IT, HR, and culture. Buyers who recognize the challenges in these areas from the outset will increase their chances of moving smoothly from post-close stabilization to value-creation activities.

Exhibit 3. Where integration has been the most and least successful for automotive firms



1 = Least successful; 5 = Most successful

Integrating IT

Involve IT upfront: To avoid unforeseen disruptions, get the IT team involved in the strategy and early design stages of the future organization's operating model.

Interfaces are key to stabilization: Managing and modifying interfaces between trading partners are critical to sales and production success for auto manufacturers, and are also generally much more intricate and complicated than in other industries (e.g. OEM trading interface certification requirements).

Don't forget your IT network: Adequately investing in this area facilitates smooth collaboration with the counterparty (e.g. target) immediately after Day 1.

Monitor IT vendor spend: Make a short list of potentially problematic vendors to avoid dis-synergies (e.g. engineering software and services such as CAD/CAM products and PLM.)

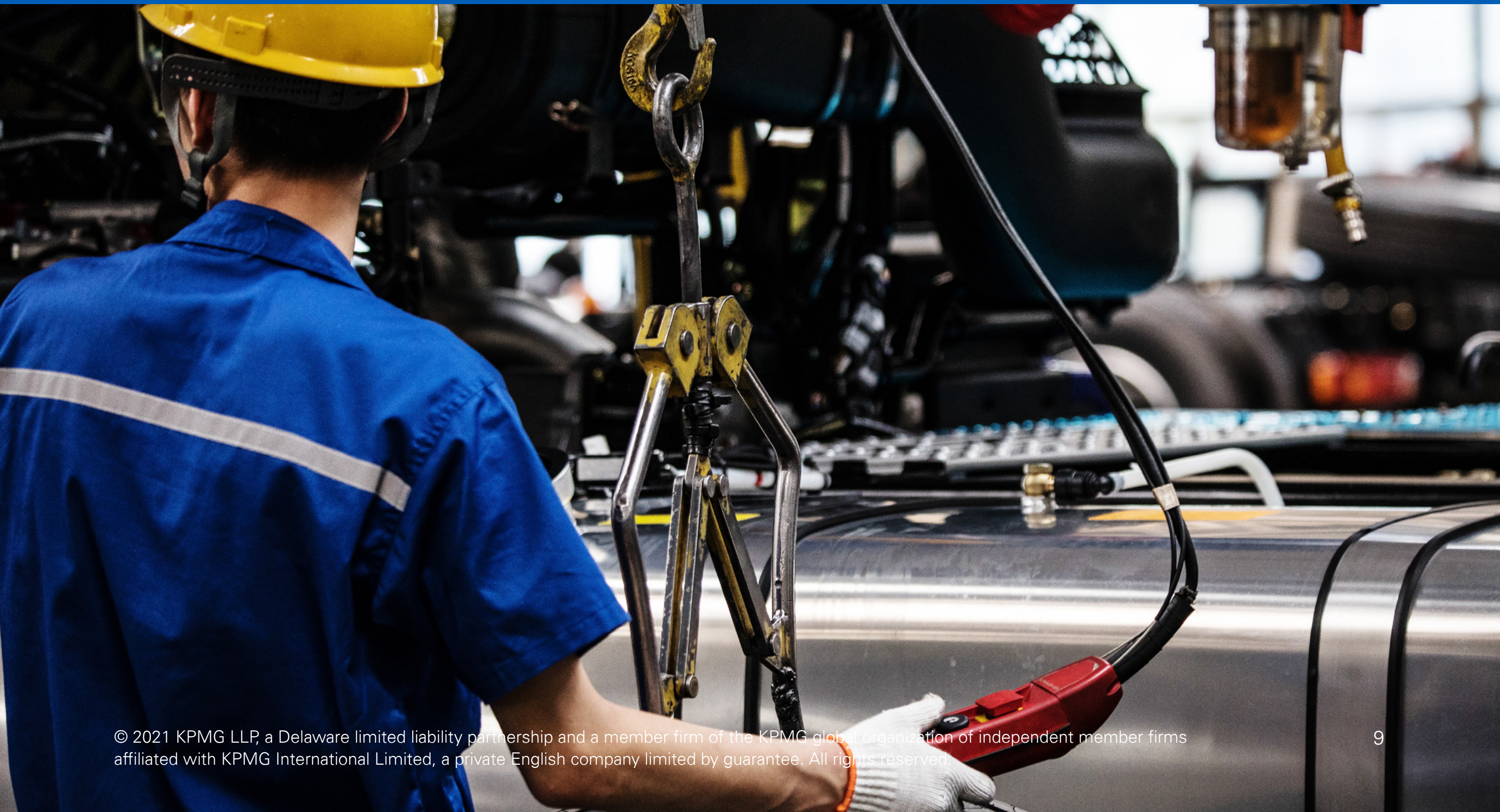
Integrating HR and culture

Make HR an early strategic partner: Much like IT, HR often tends to be brought to the table too late in the deal but can stand in the shoes of the employee to appropriately shape the change-management aspects of the transformation.

Prioritize employee experience: Avoid rushing on personnel synergies before making the transition to the new operating model to retain key players in integration.

Focus on assimilation: Assimilation breaks down communication boundaries, creates an inclusive culture and expedites decision making.

Take a "talent-first" view: When transforming the organization, capabilities and employee potential should drive decisions on people.



Seven steps to a winning integration

A successful integration is the result of thoughtful, thorough and early planning. By following the principles laid out below, automotive leaders can greatly increase the odds of a success.

1. **Commit the C-suite to support middle management**
Top management must closely partner with middle management to provide leadership for the day-to-day execution of the integration effort.

2. **Start integration planning during due diligence**
Identify the key integration projects, estimate and assign value-capture goals, and prepare mitigation steps to minimize disruption on Day 1.

3. **Identify, quantify and design synergy plans in detail**
Surprises in timing and value often result in lack of detail in the design of plans to achieve the synergies. Commit to detailed, time-bound, owner-driven plans with transparent results.

4. **Buy stability and time with transition services**
When purchasing a carved-out business from a seller with minimal support infrastructure (e.g. minimal IT, HR, finance), give yourself ample time to set up or configure your own support structure and avoid too much change.

5. **Seal the perimeter to avoid shifting costs**
Prior to pulling the lever on personnel synergies, consider the impact to temporary/outsourced spend and overtime. These two spend categories, among others, often creep into your P&L.

6. **Minimize changes during the first 30 days**
Guard against making too much change on Day 1 in critical functions such as IT, HR, operations and finance. Focus on executing the changes required to run the new organization effectively.

7. **Reassess synergy opportunities after close**
If top-down targets were set pre-close, push for a bottom-up exercise post-close to uncover additional value opportunities.

How KPMG can help

KPMG is a leading provider of deal advisory services to the automotive industry. With our multi-disciplinary approach, we can help you identify and realize value in an automotive deal.

Actively managing your portfolio
We assist clients in evaluating their portfolio of businesses to identify the right combination of portfolio moves, from freeing capital through divestitures to funding areas of growth through acquisitions.

Identifying value early in the diligence stages
We assist clients in identifying, quantifying and planning for cost and revenue synergies in the early stages of the deal.

Capturing value through integration of corporate functions and operations
We assist clients in planning, designing and implementing the future state operating model to maximize value and build a more competitive combined business. We apply a value-capture mindset to each integration decision that we facilitate—reducing cost, increasing revenue or improving margins.

Stabilizing the combined business' critical functions and operations
We assist clients in design and execution of Day 1 plans that minimize the risk of disruption to the critical functions such as HR, IT, finance and operations of the business in the first 100 days.

Carving out businesses for sale or spin-off
We assist clients in defining the assets to be separated and the optimal transaction model, as well as provide support in planning and execution of the sale or spin-off. We aim to minimize your stranded cost remaining from separating the business.

Methodology

The findings in this paper are based primarily on our experience serving clients in the U.S. automotive industry. To validate our insights, in early 2021, we surveyed 50 executives with substantial experience in deal strategy, integration and due diligence. We thank them for their generous contributions.

50
Senior executives surveyed

49
Companies represented

49%
Publically held

29%
Privately held

22%
Private-equity owned

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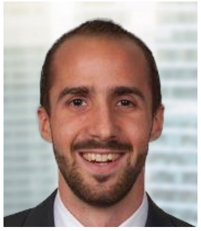

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Alex specializes in deal strategy, planning and execution for industrial clients. Bringing over 11 years of integration and transformation experience, he focuses on minimizing organizational disruption and integrating the business post-close to capture value.

We would like to thank our contributors:

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