COVID-19 and the future of the automotive supply chain

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To date, the impact of COVID-19 on the automotive supply chain has been unprecedented. The European Automobile Manufacturers Association (ACEA) estimated EU-wide vehicle production losses to be at least 2.4m units on the 1 June 2020, due to COVID-19 factory shutdowns.[1] This accounts for about 12.5% of usual annual production volumes in the region.[2]

Whilst lockdown measures across the globe are starting to be relaxed, the automotive supply chain will remain challenged by the impact of the pandemic for some time yet. This article considers the complexities of re-starting production, what we expect to see in the coming months and steps that market players should consider not only for survival but to position themselves for success in the new reality.

1 'Production impact of COVID-19 on the European auto industry' – ACEA, 1st June 2020
2 KPMG analysis of ACEA motor vehicle production data for 2018 and 2019

Life before COVID-19 - hardly plain sailing

Even before the true scale of the impact of COVID-19 became clear, the automotive supply chain was experiencing turbulence. A combination of regulatory, environmental, political, economic and technological factors have created a period of disruption over recent years, including[3]:

WLTP introduced – Stuttering sales initially due to tougher emissions tests[(a)]

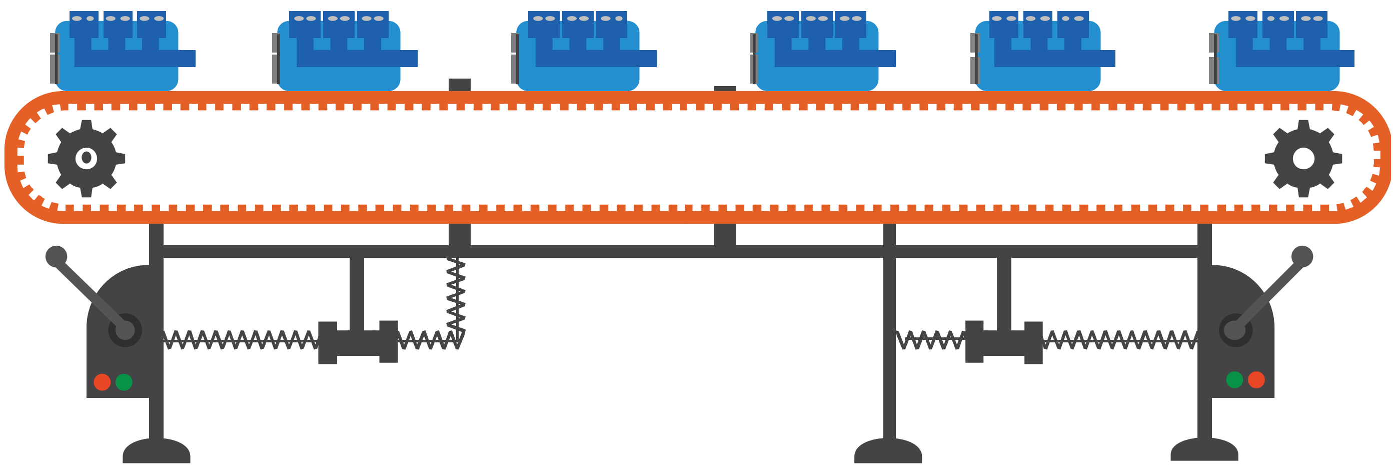
Curbs on ICE use (ULEZs, future sales bans, greater taxation etc.) – Existential questions for ICE powertrain suppliers[(a)]

Geo-political issues – Brexit and US-China tariff wars causing footprint and trade uncertainty

Signs of downward pressure on new car sales volumes – Market likely to support fewer players in future

Connected, software-driven new car platforms – Vehicle hardware commoditisation

Increasing price transparency and dealer network dis-intermediation – Downward pressure on OEM margins



Note: (a) WLTP refers to Worldwide Harmonised Light Vehicle Test Procedure; ICE refers to Internal Combustion Engine; ULEZ refers to Ultra Low Emissions Zones

This disruption has taken its toll on the industry, putting margins, cash flow and even survival under pressure. Therefore when the COVID-19 pandemic took hold, the automotive supply chain was hardly in a good position.

3 Various publically available information including 'European car sales drop sharply due to impact of WLTP tests' (AutoCar – Oct 2018), 'US/China tariff war will lose auto industry sales worth $770bn' (Forbes – Oct 2019) and KPMG Mobility 2030 analysis of LMC Automotive new car sales data accessed June 2020

COVID-19 - shutdowns, survival and staggered start-ups

When COVID-19 started to emerge in China from December 2019, there was an obvious initial impact on the local automotive market as factories temporarily closed. However, with more than 80% of the world's automotive supply chain connected to China,[4] these closures started to cause production shortfalls for global original equipment manufacturers (OEMs). As the virus spread to Europe and the Americas, a raft of temporary closures were announced from around 16 March. Several months later – after a period of significantly reduced production – most of these plants have only just started to re-open.

We are now beginning to see the true impact of these temporary shutdowns on market performance metrics. As an example, the Society for Motor Manufacturers and Traders (SMMT) recently released data for April – a full month of lockdown – showing a 99.7% decline versus the same month prior year.[5]

Looking East, as lockdown has been eased and lifted in China, we've seen automotive plants there re-open from late March. However, questions remain about the level of capacity that they are able to operate at. More recently, we've seen OEMs re-open factories in Europe and the Americas during April and May. This has largely happened in a staggered way and plants operating below capacity have been widely reported. Some European and Americas vehicle factories are not expected to re-open until late June.

We therefore seem to be leaving the first, most tangible period of COVID-19 disruption, but what does the route out of lockdown look like for the automotive supply chain?

Re-starting production: even more complex than shutting down

Governments are now looking at ways to re-start economies while continuing to protect the population. Automotive production, like many other industries, is not one that can continue to operate remotely; to make vehicles people need to be on site in factories.

When it comes to individual sites, suppliers, OEMs and specifically site managers will need to put protocols in place to ensure the right safety precautions, such as social distancing. How easy this will be will vary across and within factories – for example, based on the level of production automation and floor layouts. These precautions will be extensive – there were 100 measures reported in Vauxhall's Ellesmere Port's plans.[6] So, the practicalities of re-starting an individual site will be quite significant, but not insurmountable, and one would expect best practice to spread quickly across a heavily connected industry.

Managing the extent and timing of a re-start across the industry, however, is much more complex. Automotive supply chains stretch across multiple geographies, which will be at different phases of the pandemic and whose governments may have different stances towards opening up economies. Thousands of parts pass through these supply chains, making this a significant challenge to manage. For both individual organisations and the supply chain as a whole, coordination would be ideal here. In reality, we are likely to see uneven re-starts and a very unpredictable scaling up of capacity.

4 LMC Automotive, March 2020
5 UK Society for Motor Manufacturers and Traders, 30th April and 29th May 2020
6 Vauxhall's Ellesmere port plant begins re-start preparations, Motortrader.com

It's also unlikely that individual organisations will have enough visibility of their end-to-end supply chain. Being unaware that a supplier hasn't re-started yet, or that they haven't made it through the crisis, could bring the entire supply chain to another halt. Where is this most likely to be felt?[7]

— With Eastern Europe entering the last stages of lifting lockdown, it is more likely that engine factories and assembly plants of mainly domestic brands in the likes of the UK, France, Italy and Spain could be most affected. Turkey also recently announced and then cancelled a short lockdown for 15 cities, adding to uncertainty for Honda, Hyundai and Renault-Nissan, who all have assembly plants there.

— Production of Light Commercial Vehicles is more exposed to the hardest hit Western European markets than passenger cars.

— Beyond Europe, with Mexico and Brazil emerging from shorter lockdowns but still seeing daily cases rise, parts plants for Ford (Mexico), GM (Mexico and Brazil), Toyota and VW (both Brazil) could cause further supply chain disruption if not monitored and managed effectively.

Continued uncertainty around the relaxation of lockdown, build-up of stock in the system and the potential short-term consumer preference for used cars, means depleted demand can be expected for some time yet.

The supply chain will need to manage a slow ramp-up and calibrate this with demand. Operating below capacity and with continued uncertainty about the need for a further temporary halt will leave it fragile, with cash flow and other challenges continuing. Any further disruption, such as a second wave of the pandemic, could potentially push more suppliers over the edge. Others may decide that there is little point of re-starting production at all if new demand is still so heavily constrained. At minimum, this is likely to go on for some months but could be for longer depending on how the pandemic continues to play out.

7 European Automobile Manufacturers Association (ACEA) and Marketlines – both accessed June 2020

What will we see?

Supply-side

The ACEA recently reported a 38.5% decline in new passenger car registrations in Europe for the first four months of 2020.[8] Looking further ahead, KPMG forecasts for the UK (as an example) a 25-30% decline in 2020 for new passenger car sales versus prior year, before expecting a similar annual percentage growth in 2021.[9] More broadly, IHS Markit has forecasted a decline of 24.6% for automotive sales as a whole in Europe for 2020, but expects an upturn in 2021 volumes.[10]

As these numbers play out, what do we expect to see in the market? Firstly, it is sadly inevitable that some automotive suppliers will collapse. Arlington Automotive Group, for example, has called in administrators as it attempts to deal with the COVID-19 imposed strain.[11] Without support, a wave of other organisations can be expected to face similar challenges in the coming months.

Such support has historically come from OEMs and larger Tier 1 suppliers, who have bailed out suppliers where there is a high degree of reliance. However, with OEMs also facing unprecedented challenges, they are only expected to step in where suppliers are critical and there is little substitution opportunity.

We're also likely to see M&A and consolidation activity. Organisations in stronger liquidity positions will seek to make strategic plays or absorb some of the value-adding activities of organisations in financially weaker positions (for example, where a supplier is particularly strong in R&D and innovation, or well placed to serve the transition to electric vehicles). Funds – with large amounts of dry powder – are also likely to be interested in M&A here, especially at current valuations.

Key criteria for selecting automotive suppliers have historically been price competitiveness, quality, delivery and innovation. We can now also expect to see Tier 1s and OEMs looking for resilience in their suppliers – specifically the ability to be prepared for unexpected events and respond quickly and effectively to minimise disruption to supply and therefore production. This will likely see some supplier switching (or contingency arrangements) towards those seen as more resilient. More significantly, supply chains and routes are likely to become more regionally, or even nationally, localised in order to minimise the potential for disruption and support visibility. Governments may well lead this trend, as they look to re-ignite domestic economies.

Lastly, it's worth noting that there are reasons to be more optimistic. One example is in the area of 'gigafactories'; recent announcements include AMTE Power and Britishvolt planning to invest up to £4bn in a UK facility.[12] Such investments could generate new business opportunities and value for many automotive supply chain players across Europe and beyond in the near future. Indeed, lockdown has reinforced public support for a cleaner environment and public health. This will likely support vehicle electrification, whilst autonomous technology may be de-prioritised from an investment point of view in the near-term, until cash flow and capital limitations recede and allow businesses to re-focus attention there.

Demand-side

The industry is reportedly putting some pressure on governments to consider scrappage schemes as part of a COVID-19 recovery plan. If early automotive sector emergence out of the crisis is weak – and we've already seen some dealer groups such as Lookers announce job cuts[13] – it would not be surprising for this to be given serious consideration as a way to improve demand.

Beyond this, the hope is that as dealers re-open across many geographies, together with latent demand and social distancing measures at dealerships, the backlog of supply will start to move and make way for new production. Indeed, a recent KPMG US paper found that 25% of consumers surveyed were considering purchasing (outright or on lease) a vehicle in the next three months before lockdown and nearly half of those now have a higher intention to do so.[14] However, some ongoing consumer concerns remain: half of consumers want to test drive without entering a dealership and the large majority want to complete the purchase remotely. This should stimulate industry players to move large parts of the customer journey online.

8 ACEA press release, 19th May 2020
9 KPMG Mobility 2030 analysis
10 'IHS Markit trims 2020 global light vehicle sales and production forecasts', IHS Markit – 30th April 2020
11 "Arlington Automotive Group appoint administrators" – www.companyrescue.co.uk (May 2020)
12 'UK's first car battery 'gigafactory' to be built by two start-ups…', The Guardian – 20th May 2020
13 'Aston Martin and Lookers cut thousands of jobs…', The Financial Times – 4th June 2020
14 Anticipating the green flag: Accelerating automotive sales past COVID-19, KPMG US (2020)

Key steps for the automotive supply chain

This period will undoubtedly be extremely challenging for most of the supply chain. We believe, however, that a combined focus on short-term resilience, and developing capabilities and future business for the mid-term will help organisations build resilience through the pandemic and set themselves up for recovery on the other side. In our view, the key steps are as follows:

Short-term resilience

Protect the workforce	Providing safe working conditions will ensure workforce confidence, adherence with guidelines and could prevent a localised outbreak and further disruption.
Cash is king	Focus on operational discipline; preserve cash for essential activities, develop 13-week cash flow forecasts and plan early for financial support needs.
Open communication	Talk more to suppliers, customers and partners for increased visibility and to identify and mitigate for potential blockages. Focus on critical parts of the supply chain and on those known to be facing survival challenges.
Collaborate	Don't pull up the draw-bridge. Renew focus on industry collaboration to share ideas and tackle problems. One example is to extend supplier risk management beyond your own business, where there is mutual dependency on a supplier.

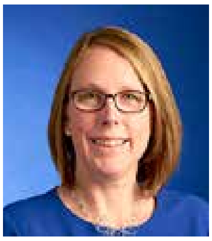
Develop capabilities and new business for the mid-term

Focus on new business	Keep a laser focus on new business development (i.e. contingent supply, new localised routes) and look to build your organisational resilience. Engage with government, where localisation may be driven by new industrial policies.
Keep an eye on M&A	Those with cash should keep an eye on the chance to access new value, build synergies or strengthen competitive positions through M&A at attractive prices. This may also help to preserve jobs and keep the supply chain moving.
Strategic focus	Survival is paramount, but this is also a time to challenge, reset and define strategies for success on the other side of the crisis. Do not lose focus on what will set your organisation up to win in the mid to longer-term.
Future mobility	Where investment needs have to be prioritised, a focus on funding electrification makes sense right now given the industry reset and the public's health and environmental consciousness. Organisations may seek to postpone investments into autonomous technology, where cash flow and capital is constrained.

Conclusion

Significant challenges remain for the automotive supply chain and some businesses will not survive. Previously distressed organisations will have seen their issues exacerbated due to COVID-19, whilst many of those who were stable will now be concerned about their ability to see this through. In this environment, the key to business survival – and future success – is resilience. Attention to the workforce, operational discipline, communication and collaboration in the short-term, combined with laser focus on new business development and defining strategic focus, will help automotive supply chain businesses to manage through survival before setting themselves up for success in the new reality.

Andrew Burn
Partner
UK Head of Automotive
T: +44 7768 474025
E: andrew.burn@kpmg.co.uk



Sarah Owen-Vandersluis
Partner
Co-Head of Mobility 2030
T: +44 7789 032546
E: sarah.ov@kpmg.co.uk

Graham Armitage
Partner
Co-founder Mobility 2030
T: +44 7710 808935
E: graham.armitage@kpmg.co.uk

Lee Swinerd
Director
Restructuring
T: +44 7770 734203
E: lee.swinerd@kpmg.co.uk

Edward Ataii
Director
Co-Head Mobility 2030
T: +44 7717 693651
E: edward.ataii@kpmg.co.uk

Edwin Kemp
Associate Director
UK Head of Automotive Strategy
T: +44 7733 308169
E: edwin.kemp@kpmg.co.uk

kpmg.com/uk

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