Growing Strategically in a Healthy Economy

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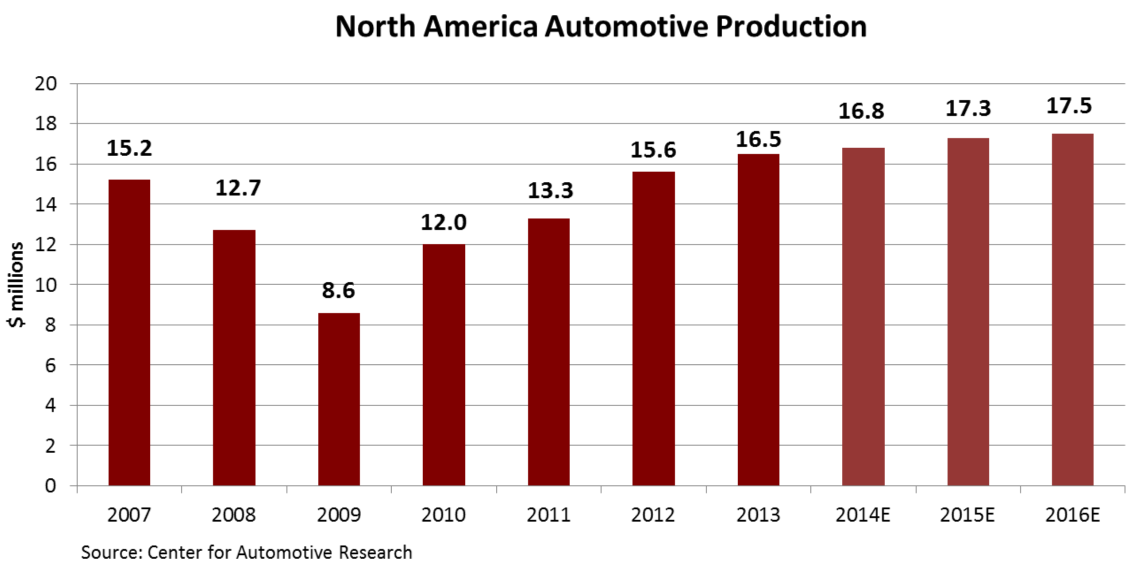
Is the Automotive Industry back to where it was in 2007? In some respects, when looking at automotive production, the answer would be unequivocally "yes." However, the manufacturing landscape has dramatically changed as a result of the recession in 2008 and 2009. Since 2009, automotive production in North America has increased at an 18% compound annual growth rate (CAGR), reaching 16.5 million units in 2013, and surpassing annual production levels experienced during 2003-2007. Moreover, automotive production is expected to increase to 16.8 million units in 2014.[1] The increase in production comes at the heels of the recession in 2008 and 2009, which caused a number of Tier 1 and Tier 2 automotive suppliers to go out of business.



According to IRN, Inc., a consulting firm with a focus on the automotive industry, automotive suppliers reduced capacity by an estimated 30% during the downturn. As the automotive industry has rebounded, production levels have surged ahead of 2007, leaving suppliers struggling to meet the increased demand. Most automotive suppliers that survived the downturn made the necessary operational improvements and became much stronger businesses coming out of the recession. As a result, many automotive suppliers' revenues have increased and incremental margins are near an all-time high (incremental margin = change in operating profit divided by the change in sales). Given the increase in automotive demand, there may be a request from large original equipment manufacturers (OEMs) to increase capacity; however, suppliers must be careful not to become too concentrated in the automotive industry. Despite having an attractive revenue stream, the automotive industry comes with its known challenges of annual product pricing reductions, strict manufacturing tolerances, and required high-volume programs. For example, from 2001 to 2010, automotive suppliers achieved productivity gains of 2.4% per year, driven primarily by OEM's putting pressure on suppliers to reduce costs.[2]

[1] "Automotive Industry Forecast." Center for Automotive Research. 25 March 2014

As vehicle production in North America is expected to reach 16.8 million in 2014 and 17.3 million in 2015, there is expected to be a shortage of supplier capacity. In a survey performed by IRN, Inc. of one hundred automotive suppliers in late 2013, twenty-eight percent responded as having issues meeting production expectations. As OEM production is forecasted to increase in 2014, capacity is expected to become an even greater concern for automotive suppliers. The logical step to meet the increase in demand would be to increase capacity. While an investment in capacity may make sense in the near-term, the cyclical nature of the automotive industry and the expectation for annual product pricing reductions required to be competitive can increase the risk of the business. In addition, as sales to the automotive industry increase as a percentage of total revenue, the value of the business to a potential acquirer can be negatively impacted. Due to the increase in risk and lower value expectations, we would caution suppliers from becoming too reliant or concentrated in the automotive market.

Furthermore, as the economy continues to improve, manufacturing businesses who serve other industries such as lighting, building and construction, medical, and consumer product markets likely have revenue and profitability at or above levels experienced in 2007. As companies begin to consider investing in their business; adding capacity, investing in automation, and hiring sales people, businesses should weigh the benefits and risks associated with adding additional revenue from any one customer or in any one industry. If a customer becomes a large percentage of revenue, typically defined as >25% of total revenue, a business becomes subject to the demands, and in many cases, the cyclicality of its customer. As automotive OEMs continue to gobble up production capacity, it is putting pressure on manufacturers in other industries to secure their own capacity. As other industries grow, automotive OEMs are luring away production capacity with large programs, and at least at the onset, higher prices.

For niche manufacturing companies serving large blue-chip corporations, companies are often able to grow alongside their larger customer. This typically requires more capital investment from the owner of the business, and keeping up with demand may be difficult as the large customer increases as a percentage of total revenue and business performance begins to mirror demands of the customer.

While the economy is growing and profit margins are improving, a large customer can be a significant driver of growth. On the other hand, the risk profile of the business simultaneously increases. The business is not only at risk of a decline in revenue from the large customer, but is also likely to receive some pushback on price over time. For an owner that is considering a transition, either selling all or a portion of their business in the next three to five years, a customer concentration can be a significant challenge and negatively impact value. Furthermore, a customer concentration in typically cyclical businesses further exacerbates the issue. In addition to the challenges of being subject to the ebbs and flows of one large customer and being exposed to potential pricing pressure, prospective buyers are concerned a large customer may move their business. Many prospective buyers are therefore hesitant to invest in a business with a perceived customer concentration issue.

As advisors to many privately owned businesses, we recommend companies limit their exposure to the automotive industry and not let one customer exceed 25% of revenue. While there may be many positives in the near-term, the risks associated with a lack of customer diversification may negatively impact future performance and decrease the perceived value by a potential acquirer.

Grace Matthews advises privately held businesses on mergers, business sales, acquisition searches, recapitalizations and management buyouts. Grace Matthews specializes in identifying the best potential strategic and financial buyers for each individual business, not only to maximize the purchase price, but also to take into account other intangible issues that are important to owners, management, and employees. For more detailed information on Grace Matthews, Inc., visit www.gracematthews.com.

2 "The Future of the North American Automotive Supplier Industry: Evolution of Component Costs, Penetration, and Value Creation Potential Through 2010." McKinsey & Company, Inc. 2012.

Reprinted from the Independent Business Association July 2014 magazine. IBAW.com