ASSESSING FINANCIAL S

AVOIDING POTENTIAL DISTRESS

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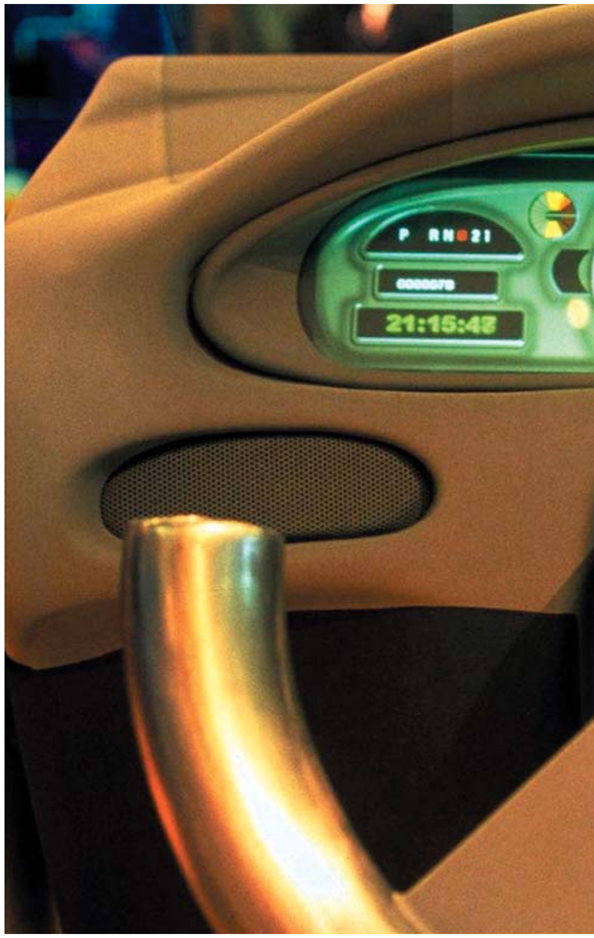
by William G. Diehl



Remarks to the* Automotive News *Manufacturing Conference in Nashville May 17

We live in an ultra-competitive automotive market that puts relentless pressure on the supply chain to drive out waste. In fact, if I were to tell you that I'm going to announce a sure-fire way to save a couple of nickels on every component, I'm sure many of you would start taking notes.

Does the figure $665 million get your attention? A recent story in *Automotive News* said one supplier bankruptcy would cost its customers at least $665 million, including loans that will never be repaid, parts price increases, operating subsidies, and professional fees.

It's been said that experience is the best teacher, but this is a tuition cost you really don't want to pay. In order to head off future distress, many OEMs (Original Equipment Manufacturers) and Tier Ones (the first or primary supplier in the chain) are carefully analyzing the operations of their suppliers. This is a sound approach.

What about the financials? In many cases, the same proactive approach and depth of understanding regarding the financial viability of these suppliers seems to be overlooked, and as we've seen the results can be costly. The most effective approach is a comprehensive proactive process that carefully monitors both the operational *and* financial health of your supply base.

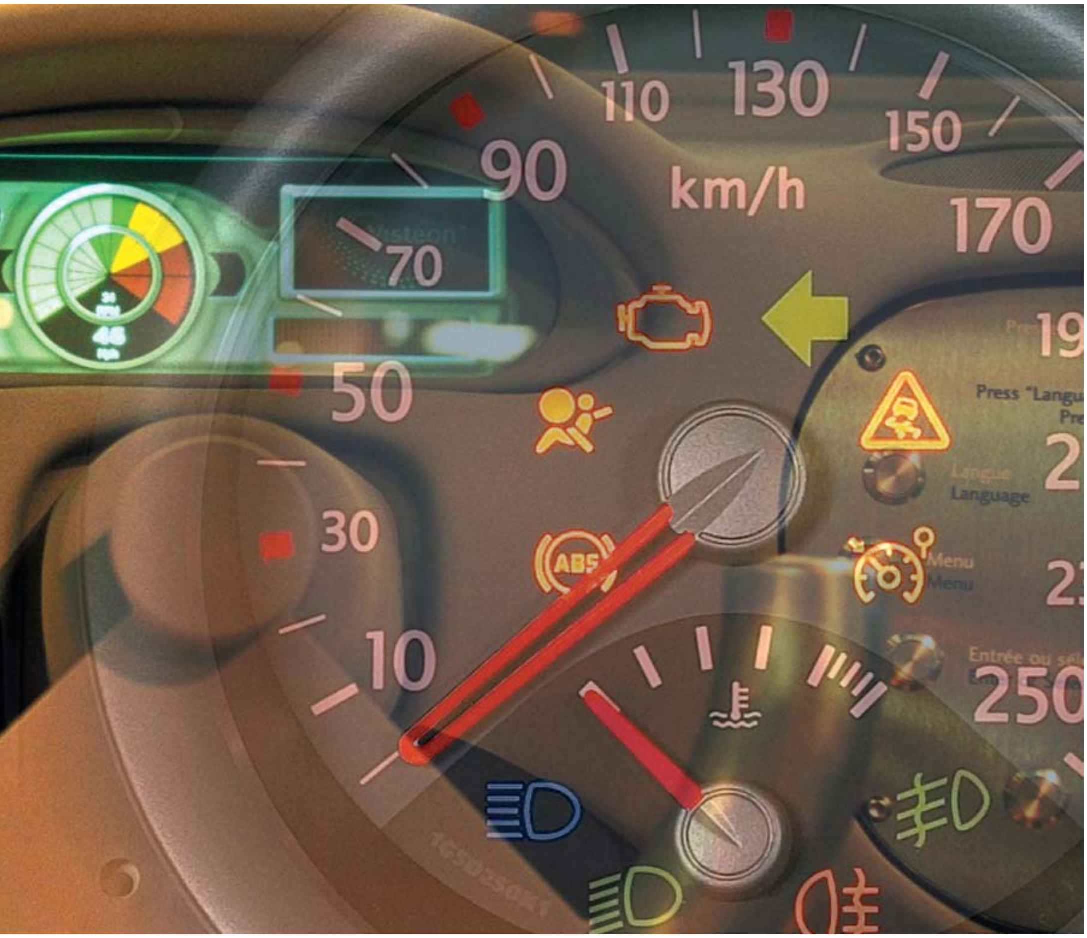
Let's face it: the reality is that a supplier can be producing and delivering a lot of product, even a high-quality product, but if the supplier is losing money on the product, it's going to run into trouble. Or that supplier could be profitable on your business, but if it is having problems with its other customers unbeknownst to you, the result can still be financial distress.

It's not news to any of you that a growing number of automotive suppliers have headed to bankruptcy court in recent years. In fact, since 2000, a total of 64 suppliers have filed for bankruptcy protection in the United States.

To understand the financial situation of the supplier base, let's take a look at some data on the trends for publicly traded U.S. suppliers. You can see in the figure on page 18 that, over a 10-year period, the gross margin trend line is down—from 24.7 percent in 1997 to 17.7 percent in 2006. Notably, the most severe declines have been in the two most recent years.

Another way to look at the picture is to examine total debt for the same suppliers over

STABILITY OF SUPPLIERS



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the 10-year period. On average, total debt has grown from $246.8 million in 1997 to $430.5 million in 2006—an increase of nearly 75 percent. The data show that the biggest acceleration in total debt occurred between 2005 and 2006.

We get a better view of the supply base from analysis resulting from our own proprietary product, BBK Ratings, a model we use for many of our clients. The model looks at both public and private company financial data, determines overall financial strength, and assigns a grade from A to F depending on the potential for distress over the next 12 months.

Based on our BBK Ratings analysis of a number of large, global suppliers, we estimate that 22 percent of the supply base could be financially distressed, which is relatively consistent with other surveys. We define a company as distressed if it has a grade of C, D, or F.

So the auto supplier industry data in total indicates that gross margins have declined, total debt has gone up, and a significant number of companies face the prospect of financial distress. Although excess capacity in many segments has been a significant contributor, it is not the only factor.

These studies were based on looking at publicly traded companies, but obviously that's only half the picture. What about private companies? In a separate study, BBK focused on privately held companies. A look at the data shows that 46 percent of these companies were

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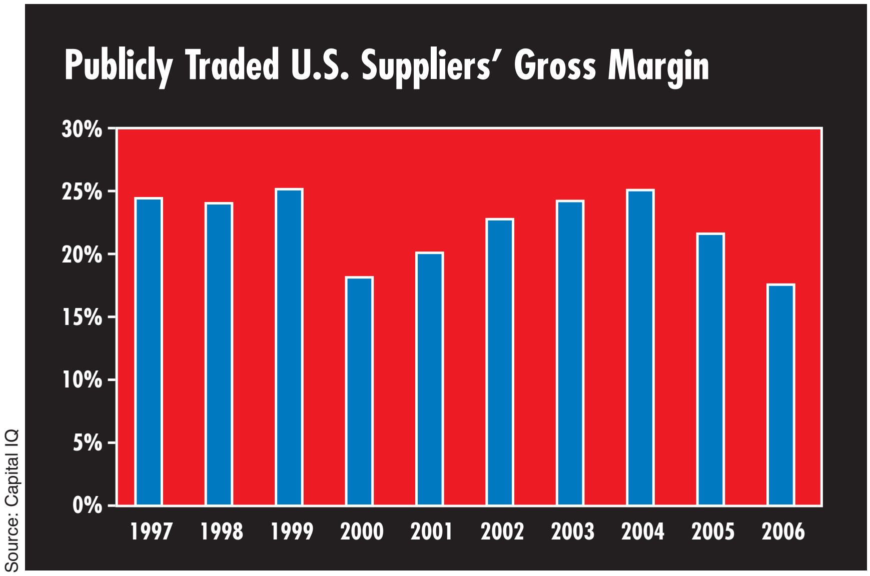

Over a 10-year period, the gross margin trend line is down—from 24.7 percent in 1997 to 17.7 percent in 2006. The most severe declines have been in the two most recent years. Additionally, total debt grew from $246.8 million in 1997 to $430.5 million in 2006—nearly 75 percent. The biggest acceleration in total debt occurred between 2005 and 2006.

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continued from page 17

rated as having some degree of potential distress with a C, D, or F grade. That is more than double the percentage for publicly traded suppliers. By the way, more than two-thirds of supply base companies are privately held!

That is how the financial health of the supplier industry looks from 30,000 feet. But if you're an OEM or a Tier One, what does all this information mean in terms of managing your supply base? It means it is critical that you pay close attention and actively monitor both the various operational performance warning signals and the financial performance of your supply base. Why? Because the cost of not taking a comprehensive approach will be a significant and costly disruption of your supply chain.

So how do you implement a comprehensive proactive process, especially on the more elusive financial side? It starts with gathering financial data. We all agree it's relatively easy to track public companies, because the data is widely available. But it's more difficult to track suppliers who are privately held and have traditionally not been required to provide financial information. However, that's starting to change, and a number of our clients are beginning to request this data from *all* of their suppliers.

To monitor these private companies, the three factors to consider are access to data, confidentiality, and cost.

In terms of access and confidentiality, you need to develop a system to gather accurate information while at the same time maintaining confidentiality if you are going to obtain the suppliers' trust and support.

On the cost side, you want (1) a well thought-out process to assess the critical areas of your supply base and (2) an inexpensive method that provides an accurate appraisal and first filter of the company's financial condition without going to the expense of a full due diligence. You can just choose one of the various services such as BBK Ratings that provide this type of information. As a first filter, it is a starting point but does not by itself guarantee that you can navigate around potential problems. Data is good only if you put it to work.

How do you benefit from this type of monitoring? The real advantage is the trend analysis and the fact that you can see trouble developing in advance and therefore work positively with your supply base to ward off distress.

You will never eliminate all risk, but your goal should be to significantly minimize surprises. A monitoring process also allows you to determine what next steps are needed to ensure continuity of production by digging deeper if needed.

Again, the critical fact is that you (1) develop a comprehensive process as to how you use the data, (2) gather the data, and then (3) stay true to the process. A proactive process will cost you money, but it will be a less expensive alternative in the long run.

Why is this financial monitoring so critical? As we saw with our look at supply-base financial data, a staggering number of suppliers face potential financial distress. In addition, there are at least three other key reasons.

The first is that time is your ally if you use it wisely and understand the problem. For example, in one case a supplier was in a financially precarious position—in fact, it received a BBK rating of F. In school an F is not a good thing and results in remedial work or expulsion. The same applies to your supply base.

The customer asked us to get involved to see if something could be done. It turned out that the problem was based on too much short-term revolving debt, which was used to support working capital. The structure of this debt put the company into a high-risk situation. After working to better understand the loan structures, with the customer's support, the company was able to go back to its lenders and obtain more flexible terms and conditions.

The net result is that the supplier was able to go from a high-risk position to a financial standing receiving a solid A rating. This improved financial position increased the potential for the company to expand its relationship with its customer.

This is an example of a customer being proactive in a positive way to work together with its supply base to ensure stability. All parties benefit.

Another lesson to take from this example is the need to understand your supplier's position at any time. That way, if things start to trend negatively, there is ample time to address the situation—and the options are less costly compared to trying to help at the last minute.

The second key reason financial monitoring is critical involves the limitations of just conducting an operations review. Most often, problems begin on the manufacturing floor and then migrate to the balance sheet, but a review of operations alone won't provide all the information you may need.

When you conduct an operations review, your supplier will show you only information related to your own parts, due to confidentiality concerns. This is why all the operational metrics you look at may come back positive but still not tell the whole story. It may be that the supplier is keeping up with your schedules and delivering quality components to you on time, and therefore you have a false sense of comfort that there are not any apparent issues. But operations may not be going so smoothly with the supplier's other customers, and those problems can eventually create financial concerns that will affect your supply chain.

The good news is that consolidation of the supply base should improve profitability via improved utilization. The bad news is that the survivors of this shakeout are larger and doing business with more customers, making it even more likely that your supplier will be affected by its business dealings with another customer.

The third key reason you should get proactively involved in tracking your suppliers' financial condition is that many suppliers are slow to recognize they may be heading for distress. The entrepreneurial mindset is a major reason for this blind spot. A lot of suppliers, especially the small and mid-sized ones, are run by the entrepreneurs who started them. Their ability to overcome obstacles has been paramount to their success. But like anyone else, entrepreneurs can become susceptible to denial. They don't want to admit even to themselves they have a problem that maybe they can't fix.

We work with a number of private equity firms that understand the importance of managing businesses in this difficult sector. However, many of the new private equity and hedge funds in the market don't understand the nuances of the automotive industry and get into trouble. Unfortunately, by the time they acknowledge a problem, it may be so late in the game that the options are slim, the costs are expensive, and the risk is very high for supplier and customer alike. On the other hand, a customer who can see the negative financial trends in advance can provide a needed reality check and help a supplier solve the problem while there are still more favorable options.

So with a comprehensive operational and financial proactive approach, OEMs and Tier Ones can work more cooperatively with their suppliers to keep the supply chain strong. This requires trust and a close working relationship between customer and supplier. The need for closer ties is widely acknowledged today as the industry responds to increasing pressure to provide consumers ever more features at less cost while meeting stringent government mandates for safety and emissions.

Although some are quick to blame the OEMs and Tier Ones for their problems, the reality is that suppliers also have a large responsibility to do their part in minimizing cost. In this drive for partnership, some of the players are further along the curve than others. There is no single cookie-cutter way to structure these partnerships; every company has a different culture and corporate governance. But one factor is certain: it is critical that suppliers be financially viable in order to contribute to this partnership.

So to sum up my message today:

- A staggering number of suppliers, both public and private, are facing financial distress, and continued market consolidation will not solve the problem.
- An operational review alone does not necessarily reveal all. Product may be of high quality and arriving on time, but the problem could be other customers or company management.
- Knowing the complete picture of your suppliers at all times gives you the ability to take action sooner and make more favorable decisions. It's good for both parties. That's why you need to initiate a strong comprehensive proactive approach that includes an operational and financial review of your supply base.

The automotive industry is known for implementing best practices, so OEMs and Tier Ones must move to employ a comprehensive financial and operational review of their supply chain. It's a strategy that will help suppliers build—and sustain—the kind of partnerships needed to be globally competitive.

Don't be at the wrong end of the learning curve. It could be very costly. ■

William G. Diehl is president and CEO of international business advisory firm BBK.

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