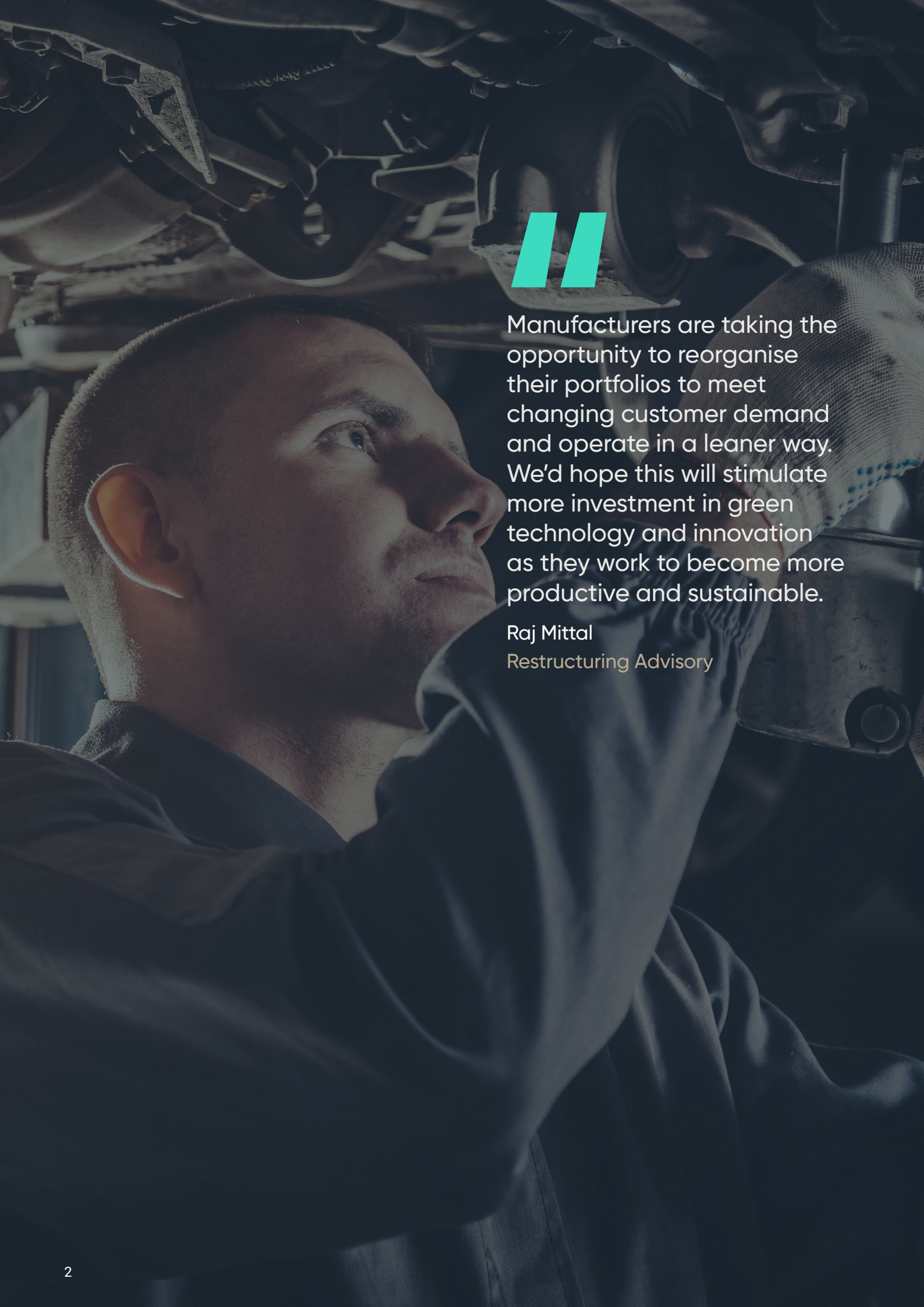


Restructuring in the automotive sector:

What does the future hold?

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Raj Mittal
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Synopsis

Britain's automotive industry generated £78.9 billion in revenue during 2019 and supported more than 864,000 jobs, making it a vital sector for the UK. Alongside manufacturers, this includes a supply chain of more than 2,500 component providers, as well as dealerships, the servicing industry and more. While there is evidence of a build-up of demand returning, this globally integrated industry was hit particularly hard by the coronavirus pandemic, with supply chains and consumer confidence experiencing severe disruption.

Here, we explore the specific challenges the industry is facing, and the immediate and long-term priorities for automotive businesses.



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What is the current state of play in the UK automotive sector?

Even before COVID-19, the automotive sector was already in a state of flux, with the industry shifting away from petrol and diesel vehicles to more eco-friendly electric models.

Alongside the challenges of reduced consumer travel, firms are now also facing the immediate challenges created by Brexit, which include subdued customer demand and volatile import prices.

This perfect storm of consumer and price pressure is also seen within supply chains, where component suppliers have long felt pressure on their margins. As such, investment in plant and machinery has fallen behind the R&D curve, leading many automotive manufacturers to question the future viability of those they work with.

All this makes for a difficult market to operate in. However, with challenge also comes opportunity and, for those willing to pioneer a new way forward, accelerating the transition to a low-carbon economy presents a chance to reimagine the shape of the sector in the next decade.

How has the COVID-19 pandemic impacted the sector?

While recent Society of Motor Manufacturers and Traders (SMMT) figures have shown some signs of improvement – influenced by the declining use of public transport and increased disposable income during the pandemic – the underlying market position has been concerning since the start of COVID-19.

Having shut their doors for long periods and returned to lower consumer demand, automotive manufacturers are taking this opportunity to reorganise their portfolios while realising that they can operate in a leaner way. We'd hope this will stimulate more investment in green technology and innovation as they work to become more productive and sustainable in the next 10 years.

This will be increasingly important as petrol and diesel vehicles will now be phased out of the retail market by 2030 – creating an increasingly competitive market where technology and quality of production will be of major importance.

What issues are businesses in the sector facing?

Working capital will be the most immediate issue facing manufacturers. As customer demand returns, plants come back online and staff return from furlough to meet the uptick in production, businesses will need to support their fast-increasing working capital requirements.

In previous recessions, we've seen that the most dangerous time for businesses is at the point of upturn. As well as managing their supply of raw materials – something that was beholden to border restrictions at the start of the pandemic – suppliers will need to engage with their key customers as early as possible and the big car manufacturers will need to support their supply chains by offering lifelines such as improved payment terms.

Firms will also need to engage with their lenders, particularly as more and more businesses are using asset-based lending than in previous downturns. Through open and honest dialogue, many short-term financial challenges can be overcome to avoid more significant ones down the line.

This poor cash position is also likely to impact on the industry's R&D investment at a time when it is needed more than ever before. Larger manufacturers will be best positioned to support the shift towards green technology. As such, we may see them helping certain suppliers to fund new product development alongside their own.

At the retail end of the market, the industry has responded to concerns about weaker consumer confidence by accelerating the shift towards more flexible subscription models – particularly rolling monthly models where consumers aren't bound by long-term commitments. We had already seen an increase in contract leasing agreements before the pandemic, but subscriptions take this a step further and should help the market become increasingly resilient.



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How is the automotive supply chain impacted? What challenges are facing the supply chain?

Very few people before the pandemic would have anticipated that suppliers would have had widespread issues securing funding and trade credit insurance. However, there's a nervousness among the lending community that many suppliers are heavily exposed to just one or two motor manufacturers. A drop in a large manufacturer's demand could have a significant knock-on effect.

This has also been a problem for spare part suppliers, who saw their sales reduce substantially as an unintended consequence of the government putting off the requirement to MOT cars for six months. Diversifying and reducing dependence may therefore be a trend among suppliers in the coming months to better enable them to access the funding they need to make their products.

Generally, firms have found that the banks, other funders, HMRC, customers and suppliers have been incredibly supportive through the pandemic but, as things start moving again, attitudes may change and favour those better placed to recover.

How will the challenges facing the sector impact restructuring activity in the market?

Restructuring has always been prevalent in automotive supply chain. It's a constant cycle that would have continued with or without COVID-19. However, some businesses will undoubtedly find that their current model is no longer fit for purpose beyond the short-term and they will ultimately struggle to access the capital they need to modernise.

There are options open to businesses in this position, including consolidation with a competitor or a sale to private equity. There is a lot of private capital waiting to be deployed but firms need to make these decisions early so they can prepare for sale before falling out of their supply chain.

What trends do we anticipate seeing across the sector over the next 12 months and beyond?

The continued drive towards a more sustainable future has gathered pace as a result of COVID-19, and the government's ban on petrol and diesel car sales from 2030 will dominate the landscape for the next five years at least, as manufacturers try to make electric vehicle production more affordable.

The Government recently announced its Green Industrial Revolution 10 point plan, which included £2.4 billion to accelerate the roll out of charging points, grants for customers to buy electric vehicles and support for the development of mass-scale battery manufacturing capabilities. Although this will help, given the transformation required to ensure the UK automotive sector is competitive and sustainable in the global market, more support from the Original Equipment Manufacturers (OEMs), Government and other stakeholders will be required.



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To plan for this transformation, we would advise that businesses in the sector consider the following:

- > Cashflow - a rolling 13-week short term cashflow forecast will be a key management tool as businesses start to emerge from the COVID-19 crisis to assist in managing the increasing working capital requirements. If a cash requirement can't be managed internally, businesses should consider approaching their funders and also the OEMs for support where they have leverage. Businesses are often concerned about approaching OEMs for support as it could impact the future trading relationship, but this can be managed if done in the right way with robust forecasts to demonstrate future viability.
- > Stakeholder management - key stakeholders include employees, suppliers, customers, shareholders, funders, landlords and pension trustees. Management will need to proactively engage with these groups to understand their agendas, information requirements and build trust to support the business's future plans. Management should consider the most appropriate finance structure for the business, particularly if further funding is required, as there are still a number of funding options available in the market, including asset based lending.
- > Scenario planning - prepare sensitised forecasts for different levels of demand and the transition to new products/customers, incorporating a proper assessment of capital expenditure requirements to consider the impact on trading and funding needs. The forecasts should also include potential performance improvements from taking the opportunity to 'right size' the business. During the pandemic, management will have identified staffing efficiencies, areas to continue to cut costs, such as travel, and unprofitable customers/products.

Reviewing these factors will highlight whether there is an opportunity to negotiate price increases or seek to exit those customers/products that do not contribute. This scenario planning will help management in considering its alternative strategic options, including a sale of part or all of the business, and other contingency plans, together with supporting discussions with key stakeholders. As a result of the transformation required and need to cut costs, we anticipate that there will be consolidation in the sector and are aware of a number of Private Equity backed businesses looking to acquire bolt-on opportunities for their existing investments.

78.9

Billion pounds in revenue generated in 2019 by the UK's automotive industry

2.4

Billion pounds to accelerate roll out of charging points

864,000

Jobs supported by the UK's automotive industry in 2019

Conclusion

The coronavirus pandemic has accelerated a number of existing trends in the UK automotive sector, while also exposing the vulnerabilities of many supply chain firms. In the short term, accessing working capital may be challenging for many suppliers as they move to increase production after lockdown.

In the longer term, the automotive industry is transforming into a greener and more sustainable sector and many well-established businesses face a challenge in ensuring they can compete in this new landscape. Suppliers need to take a realistic view of their operations. If they can't make the capital investment needed to stay competitive, their financial position may become unsustainable.

But those firms who proactively engage with customers and lenders will find themselves in a stronger position.

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For businesses to remain in control and ensure a sustainable future in this rapidly transforming sector, it is vital to manage cashflow, scenario plan and engage with key stakeholders.

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