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Sector Focus

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Driving change in the automotive sector: is it facing a perfect storm?

KEY POINTS

- The media is awash with news of concern, decline and uncertainty in the automotive sector. Falling domestic demand and lack of clarity around Brexit are two key factors.
- Confusion over diesel taxation and wider air quality plans are impacting domestic demand at a time when unprecedented technological advances are leading to growth in demand for electrically operated vehicles with driverless cars on the domestic horizon.
- The lack of clarity surrounding Brexit could have a profound impact on the sector where much of the legal and regulatory framework derives from EU Regulations and Directives.
- Decreasing domestic demand and the prospect of exports faltering if a cohesive Brexit plan does not emerge imminently means banks, OEMs (original equipment manufacturers), Tier 1 and 2 suppliers and a range of distributors need to be increasingly alert and ready to deal with distress and, at worst, failures in the sector.

MARKET UPDATE

The once buoyant automotive sector is facing some challenges. The sector has recently hit the headlines and the news has often been gloomy.

The Society for Manufacturers and Traders (SMMT) and other trade bodies, including the European Automotive Manufacturers Association (ACEA), have voiced their concerns in recent months about the impact of Brexit and other factors affecting financial performance, growth and stability in the sector. The SMMT's commentary has been widely disseminated in the UK media. This culminated in the SMMT's January figures showing that overall demand for new cars fell by 5.7% in 2017, with December representing the ninth consecutive month of decline when new registrations fell by 14.4%. On a positive note, demand for electric cars in 2017 reached a record high, with approximately 120,000 alternatively fuelled vehicles (AFVs) registered, representing a 34.8% increase. Nonetheless, AFVs remain a small segment of the sector where, by contrast, sales of diesel vehicles, a longstanding feature of the UK market, fell by 17.1% notwithstanding advances in clean diesel and reduced CO_2 emissions.

The accelerated dip in domestic demand for new vehicles, coupled with a plunge in diesel sales, is creating widespread concern in the industry. Performance in the automotive sector is regarded as a key indicator for the economy's health. Statistics vary but it is estimated that approximately 170,000 workers are employed in car factories or their supply chains in the UK, with estimates of 800,000 jobs dependent on the automotive sector as a whole. These figures will not include the impact of distress or failure in the wider business community where key plants are situated.

Much of the recent press coverage focuses on the fall in domestic demand for new cars but does not flag the huge variable in percentage terms between cars manufactured in the UK destined for export (approximately 80%) and the number produced for the domestic market (approximately 20%). Whilst the export figures have largely held up, the impact of continued uncertainty surrounding Brexit must not be overlooked. As about 50% of new-car exports are to the EU, the lack of a cohesive Brexit plan raises questions over how long the current EU export figures can be sustained.

Britain is the fourth largest producer of cars in Europe behind Germany, France and Spain. Jaguar Land Rover is Britain's largest car maker followed by Nissan (Sunderland) and BMW (which assembles the Mini in Cowley). Collectively, these three manufacturers account for nearly three-quarters of all British car production. Jaguar Land Rover invested (with significant government support and taxpayer funding) in new diesel technology leading it to build a £500m engine factory near Wolverhampton. Notwithstanding this huge investment, ongoing anti-diesel messages from the government, coupled with increased tax on diesel vehicles, has been blamed for a 30% collapse in demand.

SECTOR FEATURES AND CHALLENGES

Aside from being a sector in the grips of profound change, the underlying characteristics of the automotive sector create a significant interdependency between the key players. In the early days OEMs produced virtually everything necessary for the finished vehicle. As the complexity and number of parts increased, key components started being produced by independent suppliers or wholly owned subsidiaries of the OEMs. Over time those independent suppliers grew and subsidiaries were also sold off leading to the emergence of the current industry structure of OEMs, Tier 1 and Tier 2 suppliers and vehicle distributors.

The importance of the supply chain and the interdependence of key players on one another cannot be over-estimated, not least when the sector faces unprecedented challenge and change. An ACEA publication in May 2017 estimated that most cars now have about 30,000 parts, around 30 components and undergo over 100 process steps to become a finished product. In the course of its material journey, a car may pass through 15 countries and cross borders multiple times. Ongoing disruption in the sector together with Brexit heightens the need to guard against supply chain breakdown.

Technology presents both challenge and opportunity in the sector. OEMs are competing to produce energy efficient vehicles that will meet the demands of tomorrow's consumers. Old methods and products face the challenge of remaining relevant and competitive if they are to survive, meaning that the labour force must also be agile and open to change.

Domestic economic factors remain important. Whereas a drop in the value of sterling helps keep automotive exports levels up, the flip side of the coin is margin erosion arising from the need to import increasingly expensive components to manufacture the finished product.

BREXIT IMPLICATIONS

Brexit uncertainty continues to impact domestic demand for new cars and with it production output. With overseas demand remaining the driving force for UK car production, clarity on the nature of our future EU trading relationship and any transitional arrangements is vital for growth and productivity. The EU takes more than 50% of UK car production and multinationals such as Honda, Nissan and Toyota have specifically located in Britain to produce cars for mainland Europe with the benefit of customs-free access to the Single Market. Confirmation that the current trading relationship will not be substantially disturbed is of particular significance to businesses operating in the transnational value chain. Any reduction in tariff-free trade not only impacts price and competitiveness but also raises the prospect of disruption leading to supply chain breakdown.

The voice of business has been championed from various corners including the CBI, European Chambers of Commerce and prominent trade bodies. Consistent and repeated messages include the following:

- The need for a regulatory framework which enables growth and keeps the administrative burden to a necessary minimum. In practice this would mean a framework which closely aligns or retains the principal features of the current regime to enable the UK to stay competitive.
- Free movement which allows continued access to the right talent so that the UK can source from abroad when the necessary skills set and expertise are not available here (and vice versa).
- Tariff-free trade with the EU and other countries around the world. This is vital for the automotive sector given the significance and interdependency of the transnational value chain.
- Continued participation in European research & development projects, initiatives and programmes. This is regarded as vital for the industrial and manufacturing sectors, not least the automotive sector where new technology continues to disrupt and challenge old ways and products.

Viewed from a legal perspective, the messages from business raise a number of important legal issues where clarity on the post-Brexit position is vital – open issues include the following:

- The regulatory framework for vehicle type approval is EU governed. How will any changes impact our significant car exports to Europe?
- EU Directives and Regulations cover important aspects including vehicle emissions, technical standards, product safety and compliance. How this will be dealt with or replicated in the post-Brexit era is vital for OEMs.
- Distribution systems are governed by EU competition rules with substantial case law on price collusion and anti-competitive behaviour – what will this look like in the post-Brexit era?
- With the current web of EU legislation, how will barriers to trade in the form of tariffs be avoided – and free access to the right talent be enabled – in the future?

SECTOR SPECIFIC ISSUES TO CONSIDER

A chain is only as strong as its weakest link

OEMs and suppliers tend to enter into long-term relationships, not least because of the interdependence and complex nature of the relationship. Just-in-time stock delivery arrangements mean smooth running is essential. Any delay or failure to deliver crucial parts is likely to leave the OEM or Tier 1 supplier with little or no time to source elsewhere. In a worst case scenario it can lead to supply chain failure and substantial losses being incurred.

Litigation in the aftermath may feel like rearranging the deck chairs on the Titanic when the ship is already sinking. Preserving an open and transparent relationship with appropriate contractual back up is essential and should assist in spotting problems early and dealing with them in a timely manner.

OEMs may be willing to support suppliers with difficulties on terms. For example, by having the ability to monitor, access, and if necessary intervene, should delivery be in jeopardy. In a worst case scenario, an OEM may be prepared to support a supplier in administration providing suitable terms are agreed with the administrator, which may include the ability to pierce the moratorium in order to access and take finished parts in appropriate cases. A similar position may be adopted between a supplier and a sub-supplier in financial difficulties. Liability to deliver to the OEM typically sits with the Tier 1 supplier so it may be necessary for them to also offer concessions and support to the Tier 2 supplier on appropriate terms to ensure the Tier 1 supplier meets their own contractual obligations.

Warning signs and a pattern of events which may spell trouble

Signs of stress may include some or all of the following:

- Defaults under finance documents and other covenant breaches.
- A transfer from the bank's good book to their impaired loans team.
- Requests to fund additional working capital requirements.
- Increased bad debt levels.
- Late payments leading to litigation or statutory demands being served.

Biog box

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- Inability to respond to technological changes, losing market share and relevance.
- Inability to respond to changes in consumer buying habits.
- Worsening relationship between suppliers and OEMs.
- Over reliance on one product which loses market share.
- Too many competitors in a marketplace where only the fittest will survive.

Stakeholders who may influence a sequence of events

Typically one or a combination of the following will impact on the outcome:

- Banks and other key trading partners – are they willing to support and exercise forbearance?
- Employees and unions – job losses will often loom so the attitude of employees and the impact of union intervention may be crucial.
- Government – in large scale situations there will be public pressure to support the struggling business. How might the government respond in specific cases and more widely? For example, in the past a scrappage scheme was introduced to incentivise and stimulate new car sales whilst getting older vehicles with higher emissions off the road.
- Pension fund deficits – many large businesses in the sector will have numerous employees. Are there pension fund deficits and if so what is the plan for addressing them?
- Opportunity funds often feature where a larger business is in financial difficulties. They will be looking to either acquire bank debt and control the future destiny of the business or to acquire its business and assets potentially through an administration, free of debt and liabilities.

FINAL THOUGHTS

The challenges facing the automotive sector show no sign of abating. Businesses need a level of certainty and predictability which at present is sorely lacking on Brexit. Many will have contingency plans in place which could have adverse implications for future productivity in the UK if implemented. Those plans may well include timelines for execution. Wider challenges and disruption in the sector seem set to continue as domestic demand tumbles month on month and consumers increasingly look to energy efficient vehicles using new technology.

Further reading

- LexisPSL In-House Advisor: Practice notes: Getting the Deal Through: Automotive 2017
- LexisPSL Restructuring & Insolvency: Practice notes: Brexit – alternative UK trade models
- Brexit: life after the Insolvency Regulation (2016) 6 CRI 203