SIGNS ALONG THE WAY

Automakers and suppliers face headwinds, but planning and investments offer options

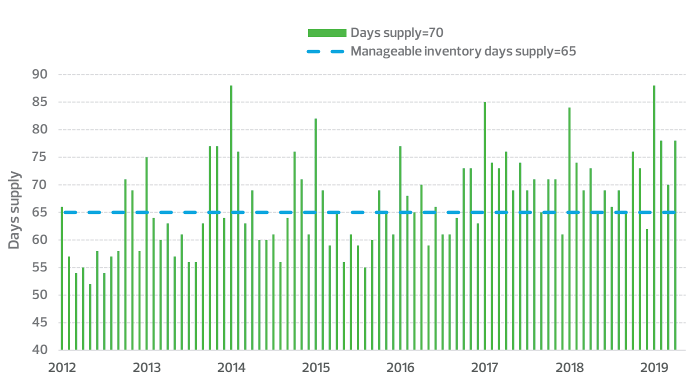
The automotive industry in the second quarter of 2019 is standing at a crossroad. Signs of a slowdown are continuing and some significant headwinds are on the horizon. Yet there also are investment opportunities for OEMs and their suppliers that would help take them in a direction to mitigate risks, gain efficiencies and remain competitive.

Bumps in the road

Declining vehicle sales in the first quarter of 2019, combined with U.S. gross domestic product growth of 1.5 percent, led the National Automobile Dealers Association and others to estimate that sales totals of light vehicles in 2019 will fall below 17 million for the first time since 2014. The decline for the year continued in April, with sales at the lowest point since February 2014.

With the inventory days' supply standing at 78 days as of the end of April (65 days is widely considered manageable inventory), it appears that sales will continue to be under pressure in the short-term (Figure 1).

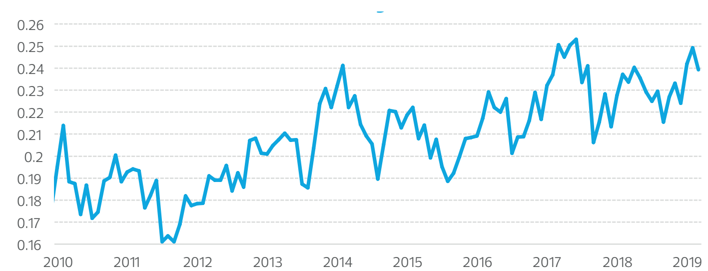
Figure 1: Inventory days' supply



Source: RSM US LLP, Bloomberg

Fluctuations in business inventories are a well-documented source of volatility in aggregate output in the United States, and much of this pattern can be traced to the auto industry. The auto inventory to sales ratio, which, along with the inventory days' supply, is often tracked to forecast production by automakers, has been trending upward since 2012 (Figure 2), a sign that sales may be slowing.

Figure 2: Auto inventory to sales ratio



Source: RSM US LLP, Bloomberg

The auto industry is now anxiously awaiting a decision by the Trump administration regarding section 232 of the Trade Expansion Act of 1962, particularly after a U.S. Commerce Department report offered national security as a reason for imposing tariffs on both fully assembled vehicles and automotive parts. While the decision was recently delayed until November, a 25 percent tariff on all auto imports could be devastating, as could any retaliatory tariffs imposed by other countries. What's more, many auto parts produced domestically—but assembled or used in finished products outside of the United States—would also be subject to tariffs as those products make their way back into the country.

The Center for Automotive Research estimates that new tariffs or quotas imposed on autos and auto parts could result in lower demand and a further drop in the U.S. gross domestic product. The Motor and Equipment Manufacturers Association (MEMA) says section 232 tariffs on motor equipment could directly impact the 871,000 parts manufacturing jobs in the United States and possibly raise the cost of a vehicle by up to $7000.

In addition, just as the summer driving season is about to get underway in the United States, oil prices may continue to rise, with West Texas Intermediate crude rising more than 20 percent since January to trade around $60. The volatile political environment in Venezuela and the removal of waivers to buy Iranian oil by the United States could lead to an oil price shock that ultimately will be passed on to consumers.

Mapping the return

Changing consumer preferences for products and services continue to fuel the need for OEMs—and, by extension, their suppliers—to find more efficient ways to manufacture and distribute their products.

But whether it's the use of robotic process automation and data analytics, or the realignment of distribution channels and contractors, it takes time, planning and capital to make these transformational and increasingly necessary changes. Yet much of the corporate investments that were expected to result from the Tax Reform and Jobs Act of 2017 have not materialized; instead, funds were often dedicated to stock buy-backs or shoring up balance sheets.

In order to sustain their businesses for the long term, successful suppliers tend to be thoughtful in their investments. But this somewhat restrained approach to capital outlays may not be in their best interests. Some are looking ahead and seeing the need to be prepared for future regulatory standards and evolving vehicle innovations.

Automotive suppliers and OEMs are actively assessing acquisitions, driven primarily by the need to gain technologies and distribution channels. Joint ventures, even among competitors, are also on the rise in efforts to manage capital expenditures as well as share technologies.

No time to be stuck in neutral

As trade tensions escalate and production costs rise, suppliers know that they can ill-afford complacency if they want to remain viable and competitive. They will need to evaluate whether they should adjust to major industry disruptions by going on their own, establishing joint ventures or making strategic acquisitions.

Trends suggest that the long-term outlook for the industry will see the creation of a smaller number of suppliers offering a diverse range of products. Suppliers will need to decide whether they can retool—or be replaced.

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