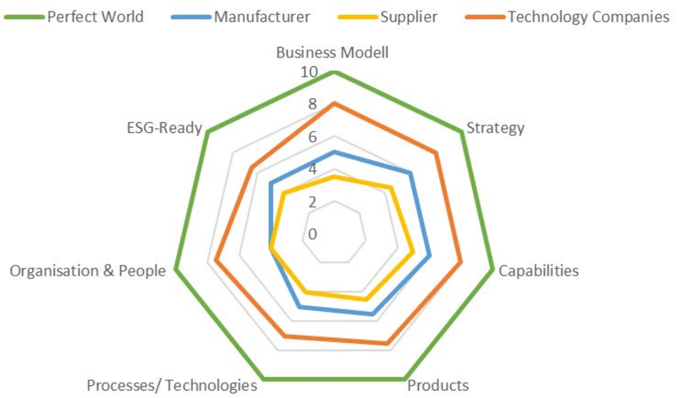
# Automotive suppliers: credit risks rise as sector plays catch-up in move to digital, sustainable manufacturing

**The automotive industry is facing a historic reorganisation. In the dramatic transition to digital and more sustainable manufacturing, much of the burden of strategic and organisational change is falling on automotive parts suppliers.**

**Credit risks are increasing significantly in the medium term for the European suppliers in this transformation toward "green automotive tech". Most companies have reacted late to the structural shift in the industry away from the internal combustion engine to other fuels and have so far only shown a weak to moderate level of digitalisation, thereby missing out on its full potential.**

**Figure 1: Auto sector falls behind tech in digital, sustainability race**




Car manufacturers have so far come through the coronavirus crisis fairly well despite stagnating if not declining sales, but the picture on the supplier side is different. In the wake of the semiconductor shortage and rising material and energy costs, profitability has weakened considerably. At the same time, suppliers are under intense pressure to adapt to changes in the automotive value chain as the industry shfits to electrified vehicles, greater digitilisation, and focus on sustainable transport.

Transformation risks and increasing degree of digitalisation are difficult to capture in the rating process. Qualitative credit assessments play an increasing role in the overall determination of the relative credit risk of companies in the automotive parts sector. Too rigid a quantitative analysis can lead to misinterpretation of traditional metrics, especially in the case of digital laggards and defensive digital followers.

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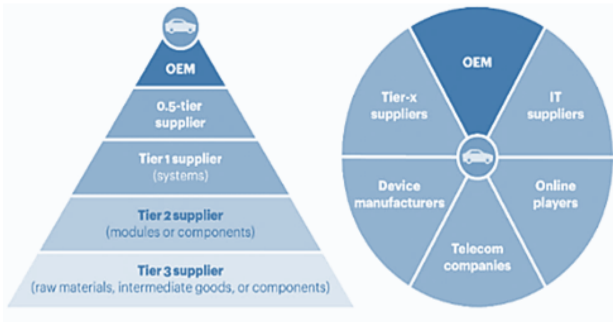
## Where value is added changes, smaller suppliers under increasing pressure

During such profound structural change in the auto industry, we expect that the way in which value is added in the manufacturing process will gradually shift.

*Structural change alters links in value chain*

**Figure 2: Automotive value chain undergoes structural shift**




Source: A.T. Kearney

*Shorter product life cycles*

European suppliers must act more flexibly and proactively to adapt more quickly to rapid changes in demand in regional automotive and transport markets.

At the same time, climate change and increasingly stringent emissions regulations are accelerating the market penetration of new propulsion technologies and require high investments in climate-neutral production and a neutral environment footprint. Issues of sustainability are increasingly determing customer demand and investors' decision-making, so the speed of industrial conversion and adoption of ESG-friendly strategy and business orientation are critical to success.

*Tier-1 suppliers lose share in new value chains*

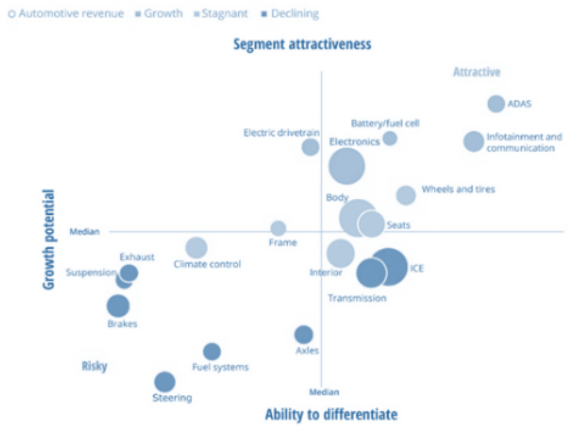
Tier-1 suppliers and system suppliers will have to link hardware and software requirements in their product portfolios more closely in future. New market opportunities will arise from the networking of hardware and the associated services. At the same time, however, the electrification of drivetrains is likely to result in a loss of share of value-added for some suppliers in the future. However, tier-1 suppliers with a global presence and diverse list of customers are less dependent on uneven development of individual regions or manufacturers, which typically has a credit-positve impact.

*Tier-2 and -3 suppliers disproportionately at risk*

Business risks increase significantly more for tier-2 and tier-3 suppliers, as they are less diversified and often specialise only in a few product groups and manufacturing technologies. In addition, most companies have weak bargaining power.

Credit risks will consequently increase significantly in the medium term, especially for suppliers with weak customer diversification and positioning in less attractive vehicle and product segments, such as conventional drive systems with declining market share.

**Figure 3: Prospects diverge for automotive parts subsectors**




Source: PWC

*Transformation strategies in shrinking and growing markets*

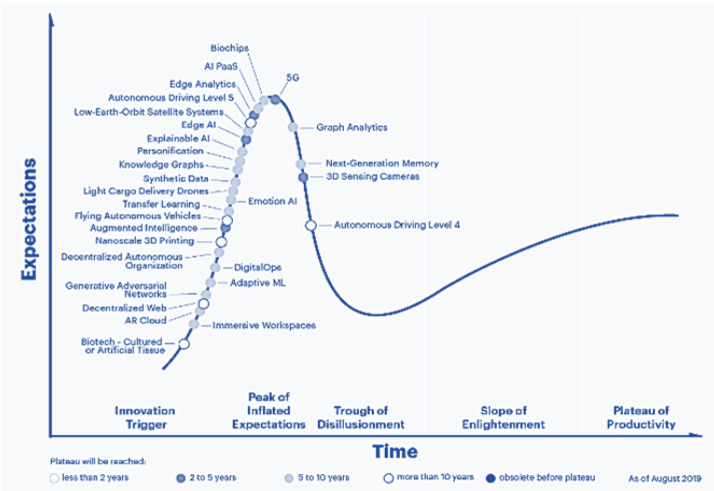
In response to the shrinking markets, some companies will pull out quickly from some segments or accelerate consolidation by buying up competitors. In the growth market of alternative drive technologies and the development of solutions for autonomous driving, suppliers are likely to seek out acquisitons and be more willing to cooperate to compensate for gaps in expertise and to save on costs.

## New technologies will accelerate transformation

*New technologies achieve new levels of development*

In the coming years, some technologies will reach new stages of development and be ready for market. Production processes and the current organisation of work will change fundamentally in many areas. Cloud computing will also take on a new dimension in the automotive sector. Instead of “cloud first”, it will often be called “cloud only”, requiring significant investment in the necessary IT infrastructure.

**Figure 4: Expectation curve for technological enhancements**




Source: Gartner

*Smart Factory approaches require increasing investments in IT infrastructure*

As in the tech industry, we expect the trend to move towards increasingly flexible microservices architectures (e.g. SAP 4/HANA). In the future, AI and IoT technologies will also increasingly find their fields of application here as a basis for intelligent factories, value chains and real-time control.

Migration pressure is also increasing on the part of software providers who will no longer maintain legacy systems in the future (including the discontinuation of SAP Business Suite 7 in 2027). Since new implementations or migrations are usually very time-consuming and resource-intensive, companies need to act by 2025 at the latest.

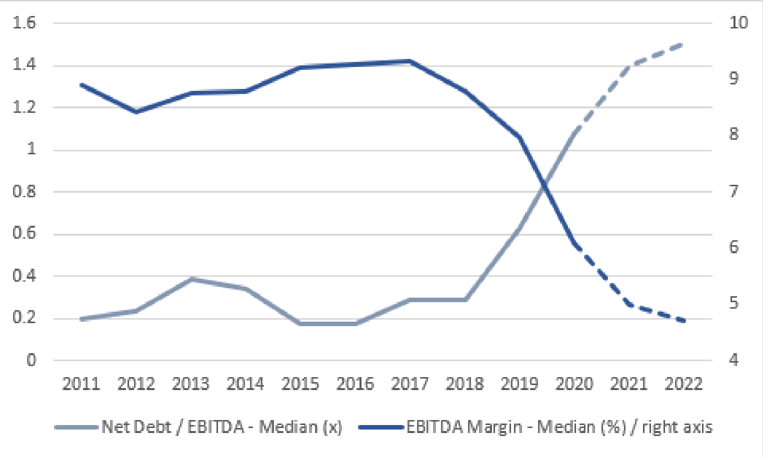
***German suppliers and manufacturers plan to invest € 150.0 billion by 2025***

Due to the high dynamic of innovation, the manufacturers and suppliers organised in the German Association of the Automotive Industry (VDA) want to invest around EUR 150bn in electromobility, new drives and digitalisation alone to maintain their future competitiveness.

***Increasing corporate debt and corona-related weakened profitability***

The median net debt of major European automotive suppliers has increased significantly over the past 10 years. At the same time, the profitability level has recently dropped to an all-time low. Smaller suppliers were hit particularly hard, as they were less able to cushion the high price pressure than the diversified mega-suppliers. Added to this are the challenges currently posed by the chip shortage-related production stops and the sharp rise in energy and logistics costs, so we do not expect any easing of profit margins in the supplier industry in the short term.

**Figure 5: European auto parts suppliers' leverage rises as profit margins shrink (2011-22)**

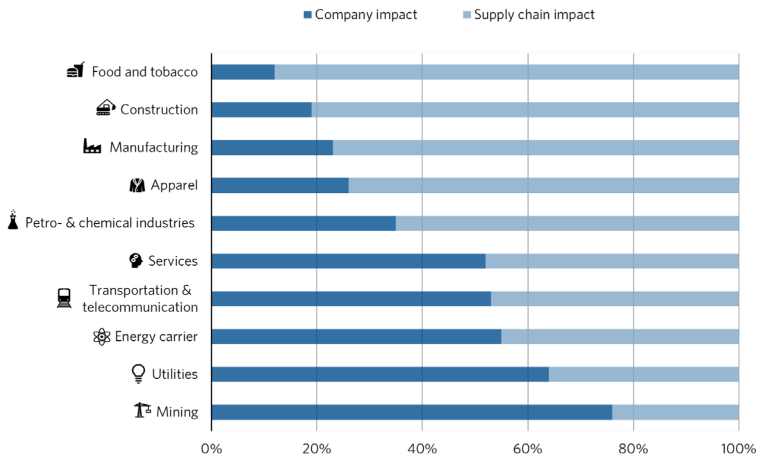



Source: Scope Hamburg

***Delayed reaction to structural change***

Even before the Covid-19 crisis, most companies reacted late to structural change and the potential of digitalisation. Most companies have only a weak to moderate level of digitalisation so far. In addition to the level of digitalisation, we believe that ESG risks and their impact on the supply chain must be assessed in a structured manner and benchmarked in the rating analysis, as they can have an enormous impact on reputation, operational and future financial performance.

**Figure 6: Manufacturing companies among sectors whose supply chais have the heaviest ESG impact**




Source: Scope Group

***Premium on qualitative credit analysis***

In summary, in the age of digitalisation and rapid industry transformation, qualitative analysis of credit quality in the automotive parts sector is increasingly important as many data points which were once good measure of industry performance no longer apply – particularly from a medium-term perspective.

Overly rigid rating scorecard models with fixed weightings and rigid sectoral boundaries havee readch their limits as historic financial and cash flow ratios need to be interpreted in the context of the industry's rapid transformation and the progress that individual companies have made toward digitalisation and making their activities more sustainable. For digital laggards and less sustainable companies in particular, the credit risks are increasing significantly.

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