

EXECUTIVE SUMMARY – TOWARDS A NEW GLOBAL ORDER FOR AUTOMOTIVE SUPPLIERS

The era of an unequivocal dominance of global automotive supply markets by the suppliers residing in Western Europe, Japan and the USA appears to be coming to an end. Stricter regulations, and increasingly demanding end-consumers have forced original equipment manufacturers (OEMs) to provide more features, at a time when these automotive OEMs are finding it hard to walk the ‘cost and productivity treadmill’ to sustain their profitability. In turn, they are demanding purchase price reductions from their suppliers, thus exacerbating the already cutthroat price competition among supplier markets that are fraught with overcapacity. As a result, many leading automotive suppliers of yesterday are facing extreme performance pressure and the need to find new sources of cost reduction or value enhancement.

On the other hand, the leading suppliers in China and India have started building their position in the global supplier industry, driven by the rapid growth in their own domestic vehicle markets and a surge in global sourcing from their geographies. In this period of transition, the triad suppliers, the Chinese and Indian suppliers, and the global OEMs are all working to position themselves for the future, as the cost imperative propels the migration of more and more parts and components businesses to low-cost countries (LCCs).

In 2004, the Vision 2015 effort for the Indian Automotive Components Industry (developed jointly by ACMA and McKinsey & Company) which highlighted that India’s automotive components manufacturing industry has the potential to grow total revenues to US \$ 33-40 billion by 2015, including US \$ 20-25 billion in exports and US \$ 13-15 billion in domestic consumption and indirect exports.

Building on the Vision 2015 effort, McKinsey & Company conducted an extensive study of over 50 suppliers based in China and India in 2005. The objective of this study was to understand the readiness of Chinese and Indian suppliers to serve the global market and to evaluate how triad suppliers and global OEMs can best prepare for the likely changes in the supplier industry. The team surveyed over 50 suppliers across China and India to evaluate their performance and capabilities in the areas of strategy, operations and product development against the triad suppliers.

The results of the survey are illuminating. We present a synthesis of our findings for the Indian industry in three sections below:

- Assessment of readiness of China and India based suppliers to become credible global suppliers
- Key imperatives for China and India based suppliers to build profitable global scale
- Likely evolution of the global automotive supplier industry over the coming decade

ASSESSMENT OF PREPAREDNESS OF CHINA AND INDIA BASED SUPPLIERS TO BECOME CREDIBLE GLOBAL SUPPLIERS

Our China and India automotive supplier survey underscores the common belief that a significant part of the overall value pool in the global automotive industry could shift to China and India based suppliers over the next decade. Even more striking is the rapid pace at which this migration of value pool could occur, and our view that the LCC suppliers will participate not just in supplying commodity parts, but also systems and modules. This is signaled by four key findings that emerged in our survey:

- Pre-conditions for rapid growth of Chinese and Indian supplier industries have taken root (e.g., rapidly developing operational skills, global customer access, proven factor cost advantages beyond just manufacturing)
- Today's manufacturing-focused suppliers are increasingly pursuing role-expansion as a strategic drive to broaden capabilities. This is not limited only to the module assembly path (i.e. the physical assembly of proximate parts), but equally visible along the R&D/integration path (i.e. designing sub-systems that are integrated through technology)
- 'Highly successful' suppliers are pursuing aggressive step-outs towards exports and/or globalization, with the LCC factor cost advantages in manufacturing and engineering capabilities providing a strong tail-wind and a competitive weapon
- Leading Chinese and Indian suppliers aspire to become global Tier-1 suppliers and are beginning to leverage overseas mergers and acquisitions to bridge the capability gaps in scale and skill

Operationally superior suppliers in China and India will demonstrate higher growth versus other LCC suppliers over the next five years, so operational excellence will remain a differentiator and cause a 'flight to scale'. However, the 'highly successful' suppliers will adopt a differentiated business model to emerge as focused suppliers of global scale. For example, 'highly successful' suppliers may pursue 'role expansion' to make use of factor cost advantages not only in component manufacturing, but also in R&D, assembly and integration. They are

also likely to leverage acquisitions to fill capability gaps, such as access to global OEMs and a footprint in new technology/global supply.

KEY IMPERATIVES FOR CHINA AND INDIA BASED SUPPLIERS TO BUILD PROFITABLE GLOBAL SCALE

In our survey, we identified several attributes of a ‘model supplier of the future’ who could command sustainable profitable growth over the coming decade:

- A **focused** business model based on a certain section of the vehicle; with the ability to **consolidate industry structure**, especially if current scale is below critical mass
- Operates on a **global scale in triad and emerging markets** with strong OEM relationships
- A champion of **operational excellence**; has a globally competitive supply chain that fully leverages the **LCC advantages**
- Focuses resources on **innovation** in products, processes, and service delivery to create value for the OEM and the end-customer
- The ability to **retain value (during OEM interactions) through role expansion** such as solution delivery, integration, and R&D

While the Chinese and Indian suppliers in our sample demonstrate a strong growth and profitability track-record, many of these suppliers are at an inflection point today. The suppliers could choose to continue to be fully consumed in responding to the innumerable requests for quotes (RFQs) from the domestic and global OEMs. However, in the longer run, as factor cost advantages diminish and/or the basis of differentiation moves away from operational excellence, these suppliers will be at a disadvantage to competitors that made more thoughtful strategic choices today that will drive longer-term growth and sustainability in margins.

The Chinese and Indian suppliers represent a strong disruptive force on the global automotive stage. Relying on their manufacturing and engineering factor cost advantages (enabled by the huge influx of highly educated engineers from their universities), and being in an enviable position of serving rapidly growing domestic markets, they hold the key to restoring superior performance to the global automotive supplier industry.

However, for the Chinese and Indian suppliers to realize their full potential, they will need to transform their business models and build new capabilities. Looking ahead, most of these suppliers will need to make strategic ‘where-to-compete’ choices, as well as pursue a vigorous ‘how-to-compete’ agenda involving

operations improvement and capability-building. Based on the survey and our understanding of what winning global suppliers of the future will look like, we have distilled four imperatives for Chinese and Indian suppliers to build a winning position in the global automotive supplier industry.

1. Define where-to-compete – go for focus and global scale in chosen verticals, and make use of the LCC advantage ‘tailwind’
2. Become operationally distinctive – it will remain a key differentiator and will drive a ‘flight to scale’
3. Achieve differentiation through the right strategic posture – go beyond manufacturing-led differentiation to include R&D, assembly, or integration contributions
4. Pursue aggressive globalization, primarily through inorganic expansion

LIKELY EVOLUTION OF GLOBAL AUTOMOTIVE SUPPLIER INDUSTRY OVER THE COMING DECADE

Our findings from the survey establishes the emergence of automotive suppliers in India and in China. Until now, triad suppliers and OEMs have taken a 'wait and watch' approach towards the emergence of a competitive supply base in China and India. Equally, most Chinese and Indian suppliers have been 'testing the waters' to explore the growing international sales opportunity. However, our findings suggest that a dramatic change is imminent and, very soon, the current trickle of experimentation could give way to a flood of activity and opportunity capture.

In turn, that flood of activity will result in significant changes in the global footprint of the auto supplier industry. For example, the production of more labor and process intensive components could shift to LCC locations and emerging market players could make large customer-seeking acquisitions in North America and Western Europe. On the other hand, when it is advantageous, existing North American and Western European suppliers of technology-driven components could move some elements of production and engineering to China and India. Similarly, to benefit from these changing supplier footprints, OEMs could significantly restructure their purchasing organization and strategies. For example, it is likely that the global buyers of commodities sourced in LCCs will also arise in these countries. Clearly, these shifts will create another set of issues that will need to be managed. For example, it may be difficult to manage the engineering interaction between customers and suppliers located across different continents, and it may be a challenge for emerging market suppliers to create and sustain a value proposition for global talent.

Overall, the emergence of suppliers in India and China could provide a new dimension to the restructuring that is likely to happen in the global automotive industry. To capture the full value from this dimension, suppliers and OEMs, both in the developed world and in countries like China and India, will need to move with speed, direction and a focus on making this exciting, though challenging, opportunity work.

APPENDIX – TAXONOMY FOR SUPPLIER CLASSIFICATION

The participating suppliers have been classified into four groups based on their relative evolution along three axes of differentiation: level of contribution to R&D (primarily application engineering and joint product development support to OEMs) involved in producing the parts they supply; level of contribution to assembly (primarily spatial integration of parts and components into ready-to-install modules); and level of contribution to integration (involving full-blown functional integration of components into systems or solutions that provide higher customer value).

System developers

A system developer—with significant integration, assembly and R&D contribution—designs and develops entire systems with unique functionality, such as the vehicle’s brake system, navigation system or locking system.

Module assemblers

A module assembler—with significant assembly contribution—performs “blue-print” assembly without detailed component R&D contribution, such as the assembly of wiring harnesses or corner modules.

Component specialists

A component specialist—with high R&D contribution—uses superior product R&D to develop functionally differentiated, stand-alone components that may be integrated into systems or modules, such as compressors, chassis components or piston rings.

Commodity suppliers

Finally, a commodity supplier—with low integration, R&D and assembly contribution—is the traditional parts supplier, with no differentiation in product R&D because its supplies, such as screws, fittings, castings and sheet metal parts, are mature and standardized.