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Restructuring in the global automotive supply industry

There is little doubt that 2005 saw one of the most dramatic shifts in direction taken by automotive OEMs and Tier 1 suppliers in decades. Many of the largest players are now squarely focused on attempting to restore financial as well as operational viability to their organisations. Having been through a decade or more of expansion – through both M&A and organic growth, it seems that the industry is poised for a downsizing and a roll-up of weaker players the likes not seen for over 25 years. The reasons for this inevitable restructuring are varied. Highly competitive market factors as well as poor business decision making have contributed to the difficult conditions that will grip theses businesses throughout 2006 and beyond.

To be sure, the automotive sector remains as one of the largest industries in the world. For example, just the automotive supply segment (Tier 1 and 2) alone is made up of over 9,000 companies employing over 1 million people and generating $250bn in annual sales. However, years of record sales within the sector throughout the 90s led to a significant amount of M&A activity and growth that was not particularly well managed. Size was gained but financial flexibility was lost. To make matters worse, many of the acquisitions by Tier 1 suppliers were designed to broaden their product lines as they grew away from the core of their expertise. The thinking at the time was that Tier 1 suppliers could use their size and breadth of product offers to compete more successfully with each other and alter the structure of their relationships with their customers, the OEMs. In retrospect, this was a poor decision as the OEMs found the international markets such as China and Korea to be a good source of competition for the North American and European suppliers. This has kept pricing at near deflation levels and making it difficult for suppliers to navigate toward profitability. While the Asian markets remain a small percentage of the total automotive suppliers (they currently represent less then 1 percent of the components used in US manufactured cars and light trucks) they are growing fast and there is little doubt they will play a major role in supplying the world's parts in the next decade.

All of these market factors mean that 2006 will see continued pressure on the suppliers to downsize, shed unprofitable business units and initiate significant restructuring plans. Some will succeed but many will fail and it is likely that there will be over half a dozen major bankruptcy filings in this sector in the first half of 2006 alone. ■

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Energy, oil & gas, petrochemicals

The high prices of hydrocarbons, which have been sustained throughout 2005, have started in motion several significant trends that will achieve prominence in 2006.

There are massive cash balances accumulating at the international oil companies (IOCs), which need to be invested in the development and expansion of reserves, either through greatly expanded exploration and production or through M&A. The high cash flows to the national oil companies (NOCs) continues to be primarily directed to the respective national treasuries, rather than in increased capital expenditure capacity and the ability to become more self-sufficient in development and production of known reserves.

We are seeing a flight of petrochemical producers to lower-cost feedstock locations, such as Saudi Arabia, UAE, North Africa, Venezuela, Trinidad & Tobago, among others. The new capacity investments are not focused entirely on the ability to build incremental capacity for the highly vaunted China and India markets, but are also being used as replacement capacity for existing plants located in high cost feedstock jurisdictions, such as the US and Europe.

There is a continued trend, at least in North America, away from combined-cycle gas turbines and gas-fired power generation and towards coal and, where possible, hydro and other non-hydrocarbon fuels (including renewables).

A few select NOCs have shown an interest in moving further downstream in the hydrocarbon value chain in order to capture more revenues. Where this has previously been demonstrated in LNG production and shipping, this trend is now expanding in the gas sector, to regasification terminals and even gas marketing. Further we see significantly increased interest among certain NOCs in more significant participation in refineries and in the distribution of new refined products, even into OECD and middle-market countries.

The flood of new projects, particularly in certain geographic locations, at all stages of upstream and downstream investment, is putting significant upward pressure on capex investments in all sectors. In the Middle East, there is 'congestion in the EPC marketplace' leading to dramatically higher cost estimates for refineries, petrochemical projects, and the whole range of midstream and downstream gas processing projects.

There are a number of ramifications arising from the trends outlined above.

First, commercial banks – even those who were sitting on the sidelines six months ago – are rushing headlong back into the energy sector in order to try to book assets, in some cases at virtually any price.

Second, the Middle East, awash with petro-dollars from the record new oil prices, is mostly keeping it 'at home' and building industrial capacity, refining polyolefins and aromatics, more LNG and metals smelting (and the power generation to drive all that). This concentration of capital expenditures in a relatively confined geographic area is driving up EPC prices and specialty steel product prices to record highs as purchase order congestion and execution shortfalls hit the region in particular.

Third, the sheer size of the capital requirements on each specific deal (e.g., the Rabbigh refinery in Saudi Arabia, whose capital target moved from $4.5bn to $8.5bn) will test commercial bank capacity available on a transaction-specific basis and on a regional basis. In certain countries with investment grade ratings and sponsors, international capital markets will return as viable funding options. In other countries, large tranches of ECA and special bilateral funding will be required to fill gaps in the debt plan (e.g., JBIC participation in Rabbigh to the extent of $2bn as a primary underwriter on the debt side).

Finally, project financing and highly structured financings will become even more necessary, despite the massive availability of capital in the Middle East, as the enormous size of the transactions will require experience and expertise in structuring in order to attract capital on a per transaction basis and on a macro industrial economic basis. ■

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