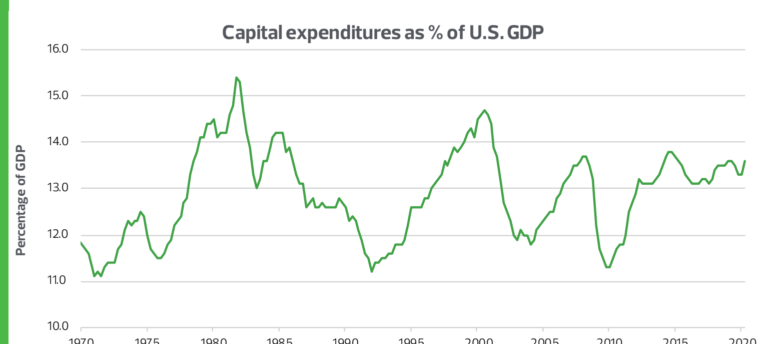
FOR AUTO SUPPLIERS, REASSESSING CAPITAL SPENDING IS KEY FOR INNOVATION

Automotive manufacturers and their suppliers have faced anemic sales for most of this year in the wake of U.S. manufacturing production plummeting 20.3% between February and April and not yet entirely recovering (September production was still 7.1% below pre-pandemic levels, according to Federal Reserve data). To deal with the economic fallout, companies have been forced to develop resilience and agility in real time while simultaneously managing their liquidity and overall financial position.

Companies' ability to effectively navigate these challenges could lead to diverging paths; some organizations might accelerate their investments and focus on digital transformation efforts, while others may stay in cash preservation mode, delaying necessary investments that would provide critical information technology infrastructure to further the implementation of Industry 4.0—referring to the Fourth Industrial Revolution—initiatives.

Given the decline in gross revenues and earnings during the prolonged pandemic, it is natural that middle market firms would pull back on all nonessential outlays of capital while carefully managing hiring, compensation, fixed business investment and inventories. While we understand that some reductions may simply be a part of the reality of 2020, there are also several moves automotive manufacturers can make to get the most out of their capital investments.

Reassess capital spending



Source: BEA, FRED, RSM US LLP

Capital expenditures as a percentage of U.S. gross domestic product have been steadily declining since peaking in the 1980s, and this capital spending restraint creates challenges for the middle market. According to data from the September 2020 RSM US Middle Market Business Index survey, "capital investment remains weak, with only 37% of respondents noting an increase on the month, and 51% stating a willingness to boost investment through end of the first quarter of 2021."

It is crucial that automotive suppliers assess and prioritize their capital projects. This involves reviewing spending to date as well as committed versus uncommitted spending, identifying how best to measure the anticipated benefits of the investment, and understanding shareholder risks. Refining the business case for any investment provides an opportunity to minimize overspending on capital projects and allows for maximizing the return on the investments.

A few key areas automotive suppliers should focus on while making these assessments include:

- **Managing** R&D spending and overall capital spending in the short, middle and long term
- **Minimizing** inventory levels and assessing other capital sale lease-back alternatives due to the economic shock from the pandemic
- **Maximizing** liquidity resources necessary for operational needs including governmental incentives, tax and other business incentives

Balancing R&D spending will continue to be a key strategic area for automotive suppliers to assess as we look forward to next year. Companies seeking immediate relief from the economic downturn might also turn to debt restructuring as an option. No matter their immediate path forward, though, all suppliers need to focus on taking advantage of available technologies, especially those focused on enabling greater resiliency and flexibility around supply chains, in order to stay competitive.

Key takeaway: Maximizing returns on investments will be key and continuing to invest in R&D around advanced technologies will be critical for suppliers' long-term sustainability, innovation and competitiveness.

Balance investment decisions

The focus on recovering from the pandemic-induced downturn has impeded many automotive suppliers' ability to execute on previously planned capital projects. Many companies are likely looking at deferring capital expenditures in order to free up cash and provide the liquidity necessary to drive day-to-day operations. But companies also need to think long term and re-forecast their capital expenditure budgets for the future.

Companies continue to look for strategies to maximize cash flow, whether through minimizing inventory levels, accelerating receivable turnover or seeking extended accounts payable terms. But as the pandemic continues, it will also be crucial that suppliers prioritize investing in digital innovations that benefit the business on a holistic level and have the greatest potential for sustained long-term returns on investment. Staying afloat from week to week is important, but this focus on digital innovation will enable companies to not only survive but thrive down the road.

Sale and lease-back transactions and other asset monetization strategies may also help auto industry players generate alternative sources of cash. Companies continue to use debt restructurings as a significant source of liquidity, to realign to the current prevailing rates and other market terms as well as available governmental debt relief programs. Business leaders should also take advantage of U.S. and global tax incentives and other programs to provide immediate cash liquidity.

Key takeaway: The industry will need to quickly reset capital project portfolios by evaluating alternative investment options and optimizing returns on the investments they make. OEMs and suppliers will need to evaluate their capital budgets and determine which digital investments will deliver the greatest return on investment across the organization, especially when it comes to driving future innovation.

Steer the strategy

As more businesses emerge from the crisis and with significant uncertainty still surrounding the virus, the case for further digitization at scale will likely be stronger than ever. Manufacturers will be looking to reduce costs and drive operational efficiencies, while at the same time creating greater resiliency and agility across the organization. To that point, 79% of respondents to a recent Manufacturing Leadership Council survey indicated their companies would accelerate adoption of technologies that enable virtual working and remote monitoring of operations. Forward-thinking manufacturers will take advantage of advanced production technologies, including predictive maintenance, plant floor simulation and modeling, collaborative robots, and artificial intelligence.

Automotive suppliers will also need to evaluate the impact of stricter emission regulations in Europe and China and how those regulations influence their current role in the continued evolution of conventional internal combustion engine-powered systems. More importantly, companies will need to carve out their role in the long-term transition to alternative powertrain technologies, as well as in innovative solutions for active safety and in-car entertainment.

The bottom line

Whatever domestic and global economic pressures automotive suppliers may face, they need to adapt and develop a plan to move forward, especially with investments in technology. These technological investments are no longer strategic; rather, they are essential. Prioritizing such investments now will not just set the table for innovations down the road, but also help businesses to be more nimble and flexible in the face of future disruptions.

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