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THE CHANGING INTEREST RATE ENVIRONMENT AND AUTO SUPPLIER INVESTMENTS

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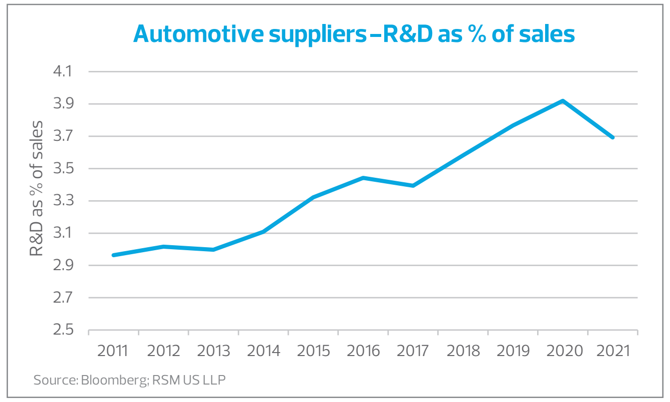
For much of 2021, historically low interest rates provided rare opportunities for auto suppliers—and companies across the economy—to make strategic investments. Now, as interest rates rise and capital becomes more expensive, auto suppliers may need to reprioritize and accelerate their investments in the electric vehicle future.

While this is far from the first time the industry has navigated rising interest rates, the current environment raises the stakes on companies' decisions about where to place their bets for the future and underscores the importance of strategic planning to drive innovation. The fact that full adoption of electric propulsion by auto suppliers is no longer a potential route but a necessary one makes planning even more crucial.

At the same time, companies will need to continue balancing the growing focus on EVs with ongoing manufacturing of internal combustion engine vehicles. Organizations may need to make strategic capital investment trade-offs, change their approach to the mergers and acquisitions landscape, and ensure they have the right leadership teams in place if they want to stay nimble and be able to adapt in this environment.

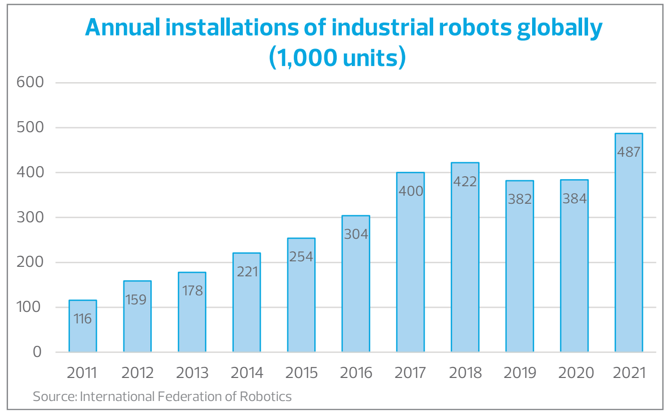
Areas of investment

It's not just electric vehicles that are necessitating innovative capital investments; autonomous vehicles, increasingly connected cars enabled by 5G capabilities, advanced vehicle safety systems, and companies' push toward using lighter materials for vehicles to drive energy efficiency are all factors that auto suppliers need to bake into their planning for the future. Enabling progress in these areas will largely come down to investment decisions related to research and development.



For many companies, these R&D investments will involve engineering modifications for the parts they have historically supplied to comply with the needs of the EV market. Such investments will include developing lighter-weight parts to support increased range. Similarly, interiors will be enhanced substantially in the years to come to provide greater comfort and utility, including making them more adaptable and refining concepts of vehicle storage. HVAC, wiring, suspension and axles are other areas ripe for development.

Finally, as automakers move closer to fully autonomous cars, they will be required to meet many enhanced safety standards. In the 2021 infrastructure bill, lawmakers highlighted their desire for greater enhancements in minimum performance standards related to crash avoidance, forward-collision warning systems, driver distraction technology, pedestrian avoidance and child protection from hot car interiors. All these examples highlight the commitment to vehicle technology that companies will need to make to remain competitive.

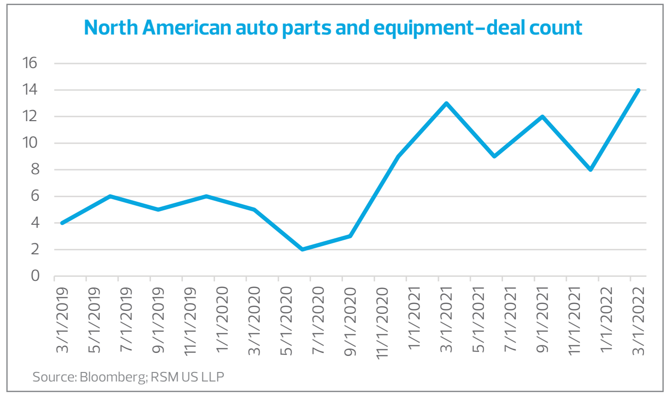


In addition to considering these strategic investments, automotive manufacturers are continuing to face the challenges of labor shortages. Such shortfalls are causing manufacturers to reevaluate their use of automation on the manufacturing floor. As reported by the International Federation of Robotics, robotic growth in North America was up by 28% in the first quarter of 2022 from a year prior, with automotive orders making up 47% of that growth, an increase of 15% from the prior year.

While investing in new technologies remains paramount, and companies need to seize on opportunities to make such investments, suppliers should also continue to assess cost reduction activities that can help boost their bottom line.

Weighing trade-offs

Suppliers may find it challenging to keep one foot in the world of ICE vehicles and the other in the future of EVs and more tech-enabled vehicles. As a result, leadership teams may be inclined to believe they need to take on more debt to make progress in these areas. But that's not necessarily the case; for original equipment manufacturers and auto suppliers alike, trade-offs should play an important role in investment decisions.



Strategic mergers and acquisitions can be key in enabling suppliers to make such trade-offs. North American automotive parts suppliers have seen approximately 100 such transactions completed since 2019, with elevated activity since the start of the pandemic. Each transaction points to suppliers' search for complementary technologies that align to their strategic role in the future of automotive.

As suppliers look to future transactions, they must be mindful of the impacts of the 150-basis-point increases to the federal funds rate announced by the Federal Reserve from March through June this year, with an expectation of an overall increase to between 3.25% and 3.5% by year-end. These rate increases not only will mean more costly sources of funding for such transactions and lower margins in subsequent years, but also will likely impact the flow of M&A activity over time.

Organizations continue to ask themselves how soon they should throw all their effort into EVs—but given the infrastructure hurdles to widespread EV adoption in the United States, it will be crucial to maintain a balance between EV manufacturing and ICE manufacturing.

Key leadership considerations

Along with formal mergers, suppliers should assess opportunities for joint ventures and strategic alliances with other organizations that can improve their resilience for the future. Shared investment can bring a range of benefits, including access to other companies' technologies, risk mitigation and a collaborative approach around R&D.

Such partnerships may require a mindset shift, especially among legacy organizations. Companies shouldn't be afraid to question or reevaluate whether they have the right people at the table on their leadership teams and boards. Members of those teams should be forward-looking and well-versed in technology, and don't necessarily need automotive industry expertise to help guide suppliers into the future. In fact, outsiders can bring a distinctive advantage in some situations, especially if they have a background in advanced and/or emerging technologies.

Leadership teams should also assess how third-party organizations can help with business process analysis, supply chain assessments, and other projects, to get greater visibility into operational pain points and how to alleviate them to better enable future success.

The takeaway

Whether balancing EV and ICE operations or balancing various approaches to accelerate R&D—through technology investments, strategic partnerships or cost-cutting measures—automotive suppliers need a thorough understanding of how the changing landscape for capital will affect their planning and operations.