

CONCENTRATION, CONSOLIDATION AND COMPETITION

The ICE to electric transition
and M&A in the Automotive
Supply Chain

Structural and technological shake-ups in any industry don't simply alter future value opportunities. Transitions of this magnitude offer huge value creation potential in the immediate evolving state, not only for firms seeking to exit profitably but also those that can successfully transition from one structure or technology to another.

The seismic transformation currently sweeping through the automotive industry is a shift away from the internal combustion engine (ICE) to battery electric vehicles (BEV). This change is leading to a wholesale shift to alternative vehicle propulsion, unravelling an ICE supply chain constructed over the previous 100 years. Indeed, numerous major car markets have set the 2030s as the decade new ICE vehicles can no longer be sold.

The 2023 AlixPartners Automotive Outlook details how this strategic restructuring has already catalysed an inevitable uptick in auto part M&A activity, as consolidators emerge, and private equity interest grows.

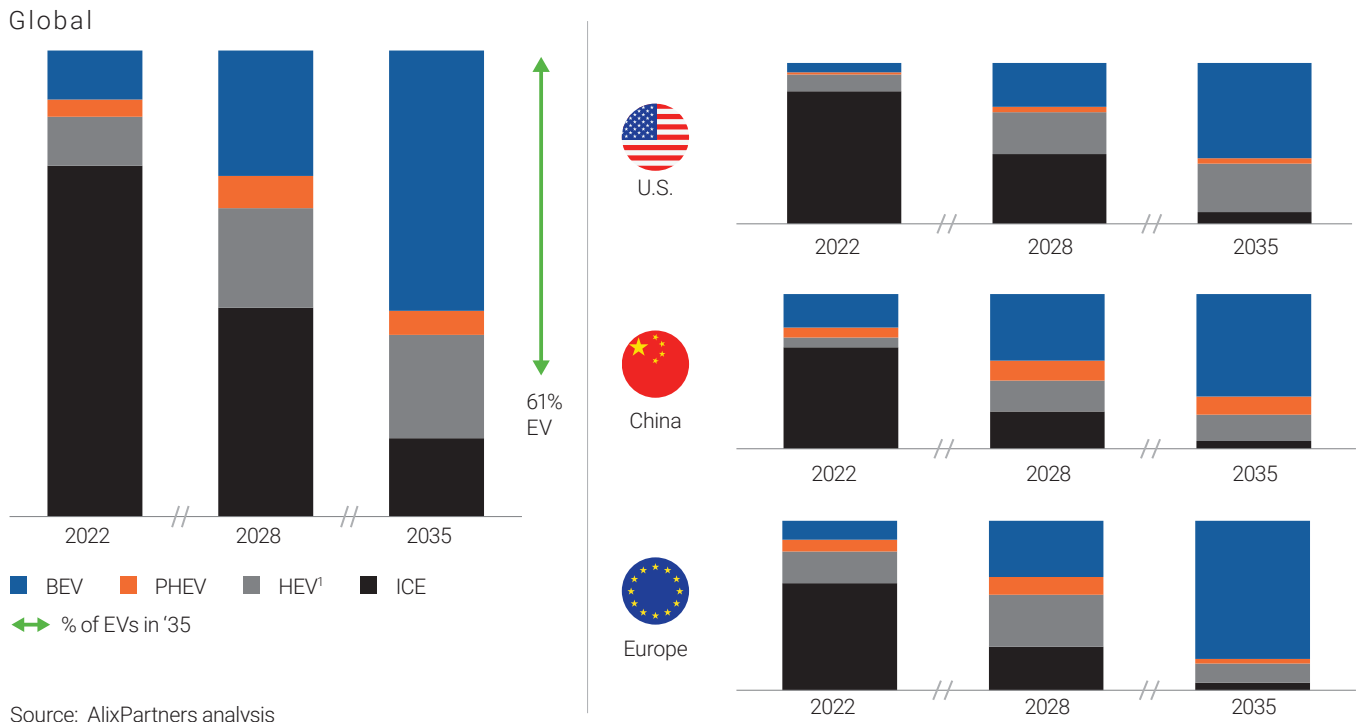
In the near term, M&A activity in the automotive supply chain has the potential to create a deal backlog, with regulators scrutinising competition and companies needing to establish legal separations and transition service agreements in relation to businesses that will be divested.

AlixPartners has carried out a detailed review on over 800 global suppliers and mapped 2,693 entities that supply ICE components to the Original Equipment Manufacturers (OEMs) within them. Some of these entities are easily defined business units, while others range from dedicated ICE-component factories to ICE-focused internal operational structures or product groupings.

Many of the world's largest suppliers have already indicated whether they wish to be an ICE-consolidator, transform existing ICE-related units to new BEV supply, or exit the ICE supply business altogether. Some, like Continental, have completed their exit already.

There is now a relatively clear BEV transition roadmap and the time to move is right for those suppliers or funds yet to finalise their strategies. Terminal values are clearer to calculate, and those that want to exit risk being left holding assets with limited residual value.

FIGURE 1: FORECAST GEOGRAPHICAL TRANSITION FROM ICE TO BEV

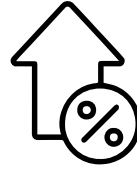


ICE MELTING; A TRANSFORMING MARKET

New ICE component sales to OEMs across transmission, engine systems, drivetrains, and fuel systems are expected to decline steadily from this point forward.

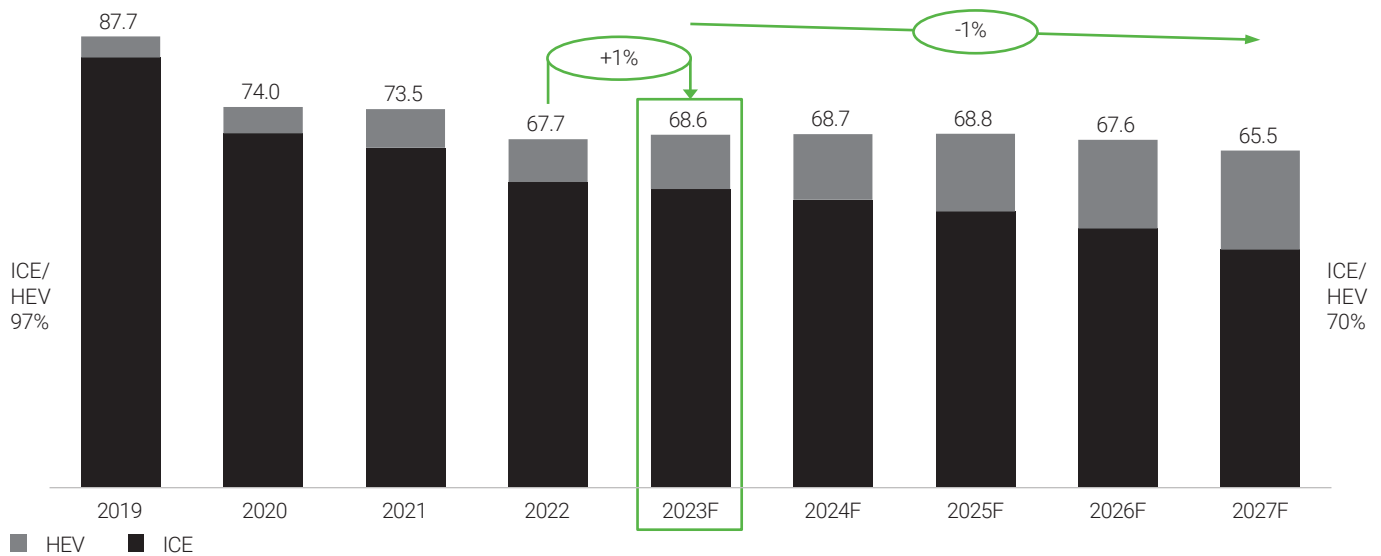
This transition becomes clear when reviewing annual sales volumes. Despite the post-pandemic and semi-conductor overall market recovery, ICE sales are only predicted to grow 1% in 2023, before shrinking consistently year on year afterwards. AlixPartners predicts that ICE will only constitute 70% of the market by as early as 2027 (see Figure 2).

ICE SALES ARE ONLY PREDICTED TO GROW



1% IN 2023

FIGURE 2: GLOBAL ICE AND HYBRID LIGHT-VEHICLE SALES (UNITS, MILLIONS)



Source: S&P Global Mobility, EV-Volumes, AlixPartners analysis



CONSOLIDATION

Against this backdrop, the case for consolidation among ICE suppliers continues to grow. Those preparing to be the “last person standing” seek those that want cash now to reinvest in transforming their business to BEV through the disposal of ICE entities that are no longer core.

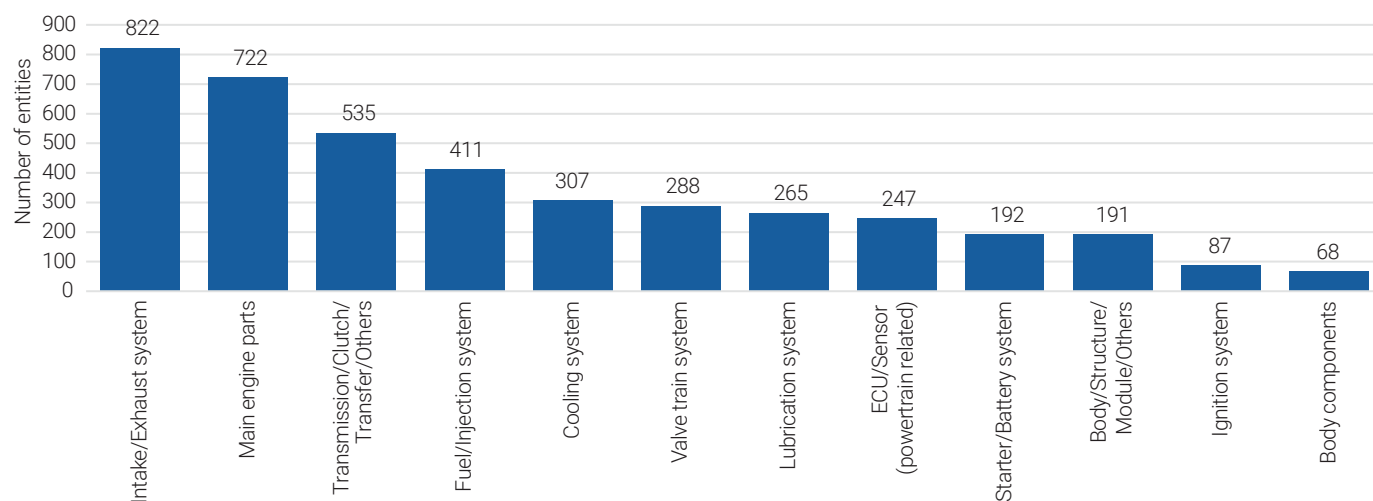
And this uptick for ICE-related supplier M&A has already begun. Automotive supplier-related M&A activity reached its highest level for five years in 2022, driven by a 67% increase in ICE-related deals. This was in a year in which the automotive industry performed better than other industrial areas: in terms of value, automotive was up around 4.5% versus the industrial sector fall of 16% from 2021 to 2022. These deals also took place amid a drop-off in listings and special purpose acquisition company (SPAC) creations from 2021 highs.

It is also clear that private equity is now in the driving seat for automotive dealmaking, accounting for 71% of ICE transactions based on 2022 deal value.

Sales of ICE business units have been supported, as these assets trade at a discounted market valuation; a diversified automotive component supplier is likely to be valued at 10x earnings (EBITDA) multiples, while an ICE business trades at approximately 6x earnings.

However, deciding which sub-sector to consolidate is a highly complex task, requiring a deep understanding of the existing global supplier map for each component. The AlixPartners market review categorises each supplier entity into a category, sub-category, and primary component to identify which entities exist, their competitors, and overall market concentration levels.

FIGURE 3: NUMBER OF UNIQUE SUPPLIER ENTITIES PER AUTOMOTIVE SUBSYSTEM



Source: MarkLines, S&P Capital IQ, AlixPartners analysis

As consolidation activity increases, more embedded entities will need to be carved out and then integrated into a new parent. Yet many of these entities will not be independent business units with their own management, systems, or even physical locations. They may, however, hold the extremely valuable asset of long-term contracts with their OEM customers, although they may be held in separate sales or geographical units.

Therefore, preparations for carve-outs will be complex and time consuming for sellers. Critical activities, including the creation of new entities with their own legal structures or technical service agreements (e.g., for IT, business services, or rent), will also be further complicated

should the newly created unit span multiple geographies.

For buyers, meanwhile, ensuring a true synergy effect and that the right assets transfer with the right contracts – including highly valuable aftermarket contracts – will be a laborious task, first with identification and then with execution.

MARKET CONCENTRATION MAY LEAD TO COMPETITION CONCERNS

Given the factors described above, market concentration in the automotive supply chain will be an ongoing focus for competition regulators globally, as they endeavour to preserve competition in each market in the face of declining demand. Whilst there are a large number of entities at system level, there is considerably more concentration at the sub-system and parts level.

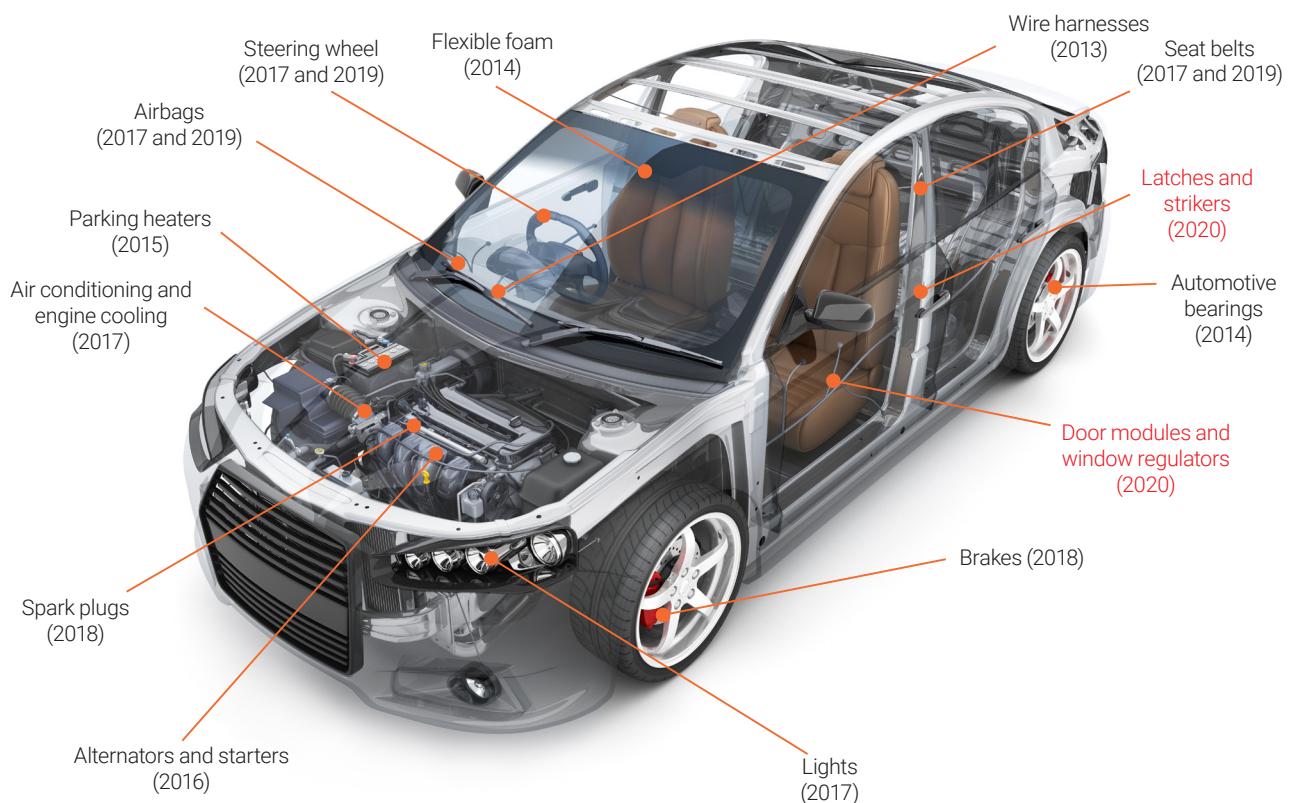
OEMs typically go out to tender for different car parts, and in many cases have specific or bespoke requirements, rather than buying standard parts used across OEMs.

The key question competition authorities will be asking is whether OEM customers have sufficient choice following any M&A activity, particularly in sectors with a shrinking number of suppliers pre-transaction. In such circumstances, competition authorities may be concerned that it may

become profitable for the merged business to increase prices unilaterally if the merger reduces the negotiating power of OEMs in terms of the number of alternative suppliers to whom they can switch.

Competition authorities may also be concerned about mergers facilitating competitive coordination between suppliers, including tacit coordination between suppliers as well as explicit coordination (i.e., illegal information sharing and cartels). A large number of auto part cartels have already been found, and fined, globally over the last ten years or so, as highlighted by European Commission (EC) findings below in Figure 4.

FIGURE 4: COMMISSION HAS FINED CAR PARTS CARTELS ALMOST €2.2 BILLION SINCE 2013



Source: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1774

There have been several mergers already in various car part markets, of which the majority have been cleared (albeit some subject to commitments). Whilst not ICE related, the merger between Novelis and Aleris (2019) is notable, involving two suppliers of automotive body sheets. In its competitive assessment, the EC found that the merger would significantly impede effective competition because the transaction would result in the parties controlling a large share of the output, which would give the merged entity significant pricing power.

To clear the merger, the EC required the divestment of Aleris' whole Aluminium automotive body sheets business in the European Economic Area (including a major manufacturing plant), removing any overlap and competition concern.

Similarly, in the merger between Accuride and Mefro Wheels (2018) – two suppliers of steel/aluminium wheels – the EC concluded that the parties were close competitors, and the OEMs would be deprived of supplier choice. As a result, the parties had to divest Accuride's holding of a plant in northern Italy to remove the competition concerns.

These two cases also highlight the importance of acting quickly and early in the consolidation process where more competitors remain, since competition concerns are less likely before the number of suppliers in the market significantly contracts.

It is also important to identify key competition risks very early in the process and consider what remedies might be available if the relevant authorities find that the merger raises competition concerns.

Competition authorities may also be willing to clear mergers unconditionally if one of the merging parties' financial position is such that it and its relevant assets would, in any event, exit the market in the near future and there is no less anti-competitive purchaser.

However, satisfying these criteria presents considerable evidential challenges. Moreover, from a commercial perspective, this will be a poor outcome for the seller's shareholders as the sale price is likely to be low. Clearly, it would be better that such disposals are made before the seller's business becomes so precariously positioned, if possible.

As well as this robust market and regulatory position, there is the need for sellers to determine how to carve out business units, from legal separations to service transfer arrangements. Early analysis of consolidation strategies and their rationalisation will be vital to create an approach that can be rolled out while avoiding strategic roadblocks.

Then there is the question of where the value lies. One company may need to target greater EV exposure, depending on its product segment, while another could target the profitable aftermarket as the servicing needs of ICE cars extends into the 2040s and beyond.



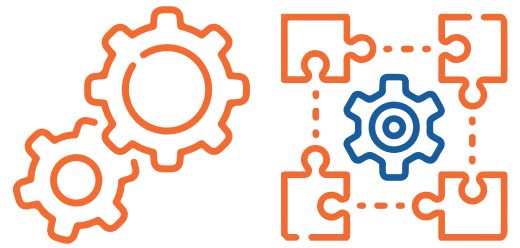
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AND CONSIDER WHAT REMEDIES MIGHT BE AVAILABLE

THE IMPERATIVE FOR ACTION IN A CONTRACTING MARKET

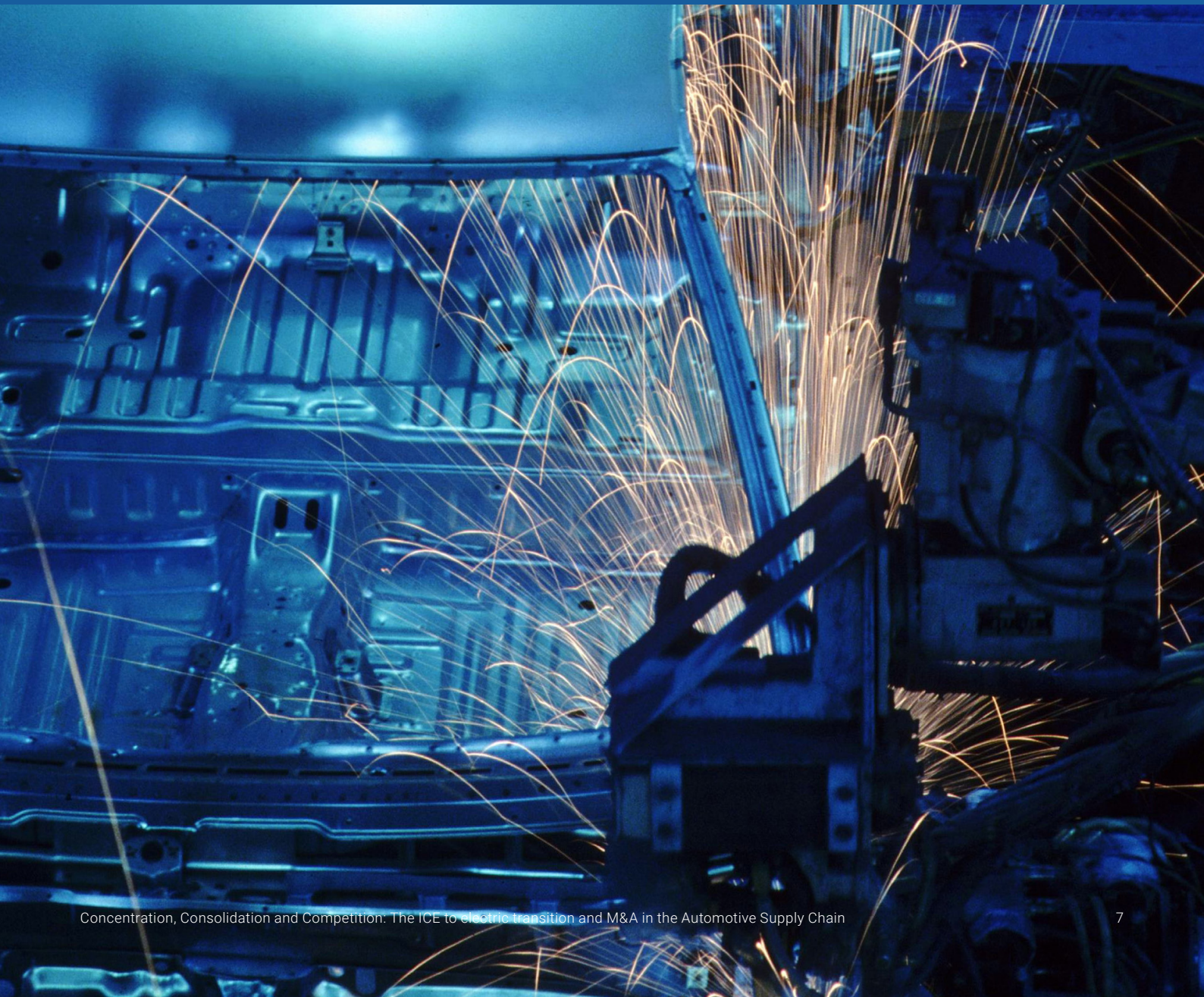
The transition from ICE to BEV is intensifying, demanding action in the shape of evolution – or market departure – for ICE-focused automotive businesses.

The accelerating deconstruction of the ICE supply chain will create high levels of M&A activity in the near future, as market players seek to harness the opportunities presented by market consolidation.

Strategies will swing between building economies of scale and efficiencies on the journey to becoming the last supplier standing or simply realising the greatest asset value on exit.



One factor will remain constant, though: Deal and operational success will depend on smart, timely interpretation of how the sector is evolving and where the value lies, with a strategy in place to manage the competition complexities that will emerge as the market contracts.



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For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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