

gearing up: getting more growth capital into the UK's automotive supply chain

By Andy Rumfitt





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The Society of Motor Manufacturers and Traders (SMMT) is one of the largest and most influential trade associations in the UK. It supports the interests of the UK automotive industry at home and abroad, promoting a united position to government, stakeholders and the media. The automotive industry is a vital part of the UK economy accounting for £40 billion turnover and £8.5 billion value added. With over 700,000 jobs dependent on the industry, it accounts for more than 10% of total UK exports and invests £1.5 billion each year in R&D.

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This report forms part of the Institute's 'policies for change' programme, which looks at what more could be done to rebuild and rebalance the economy. The work was supported by the SMMT, which acts as the voice of the motor industry, and who want to get a better understanding of the relationship between the financial sector and the UK's fast changing automotive supply chain. Andy Rumfitt, an economist and expert on the dynamics of growth, has accomplished that task and provided insights on the market conditions and potential for expanding the sector. In particular, he has made a number of practical recommendations to help increase investment in the critical smaller and medium sized suppliers. The Institute would like to thank Andy for his work and Paul Hunter for editing this report. We also gratefully acknowledge the support of Paul Everitt, the chief executive of the SMMT and offer special thanks to Konstanze Scharring, head of Public Policy & Vehicle Legislation at SMMT, for all her advice.

Paul Hackett, Director of the Smith Institute

Executive Summary

With the potential for expansion and stabilising market conditions, the UK's automotive supply chain can be at the heart of the Government's plans to rebalance the economy. But only 36% of a £7.4 billion market is sourced from UK based suppliers. Despite a roadmap of potential opportunities, suppliers face a number of challenges including being cost competitive on a global scale, achieving the demanding quality standards of volume car manufacturers and accessing affordable finance. From this initial study there is clear evidence that the automotive suppliers and the UK's financial sector can work together much more collaboratively to understand the supply chain dynamics and the specific operational issues of these firms. With improved financing these manufacturing firms will be more able to create wealth and add jobs in parts of the UK badly hit by the current recession.

1. Introduction

As an important and relatively high profile sector, this paper puts a spotlight on the potential of the UK's automotive sector and, in particular, its UK based supply chain to expand and to see whether there are any financial constraints that are holding this growth back.

2. A renewed focus on the importance of manufacturing to the UK economy

Following the credit crunch and subsequent recession, the Government identified that an over reliance on the financial and service sector was a problem for the UK economy. In response Government policy has stressed the need for a rebalancing of the economy:

The UK needs to move away from an unbalanced growth model reliant on a narrow range of sectors and ever-increasing government spending. We can no longer have an unsustainable accumulation of private debt that inflated property bubbles and ultimately caused a banking crisis and sharp falls in output. The UK needs to grow sustainably – both economically and environmentally. We need to grow, but we need to grow differently.¹

The resulting policy thrust has focussed on providing the stability that business needs to plan and invest; making markets more dynamic by removing barriers to growth wherever possible; focusing the Government's own activities on providing the conditions for private sector growth and investment; and ensuring that strong growth is fairly shared and sustainable in the long-term. A key element of this approach has

¹ HM Treasury/BIS *The path to strong, sustainable and balanced growth* (November 2010)

been the desire to maintain a flow of finance to viable businesses so they can invest and grow and that innovative ideas can continue to be brought forward. The aim has also been to expand the UK's private sector and manufacturing base to create sustainable employment, especially in areas with an over dependence on public sector activity. The future growth of the UK based automotive supply chain is a good test of the Government's desire for such an industrial rebalancing.

3. Long term decline in manufacturing employment

Over the last 30 years the UK has lost 3.2 million manufacturing jobs, more than halving the size of the sector. From 5.7 million jobs in September 1981 manufacturing employment contracted to just over 2.5 million jobs by March 2011. However, total UK employment has increased by 5.2 million jobs since 1981 due to a massive expansion of service sector employment in both public and private sectors and at all occupational levels. The health and social service sector has doubled in size, adding more than 2 million jobs. Professional, scientific and technical services have trebled in size, adding more than 1.5 million jobs. Administrative and support service jobs have more than doubled in size, an increase of more than 1.2 million jobs (see Annex).

Despite this structural change, manufacturing still remains important to the UK economy as BIS notes:

In 2009, manufacturing was the third largest sector in the UK economy, after business services and the wholesale/retail sector in terms of share of UK Gross Domestic Product. It generated some £140bn in gross value added, representing just over 11% of the UK economy. It also employed some 2.6 million people, representing over 8% of total UK employment.²

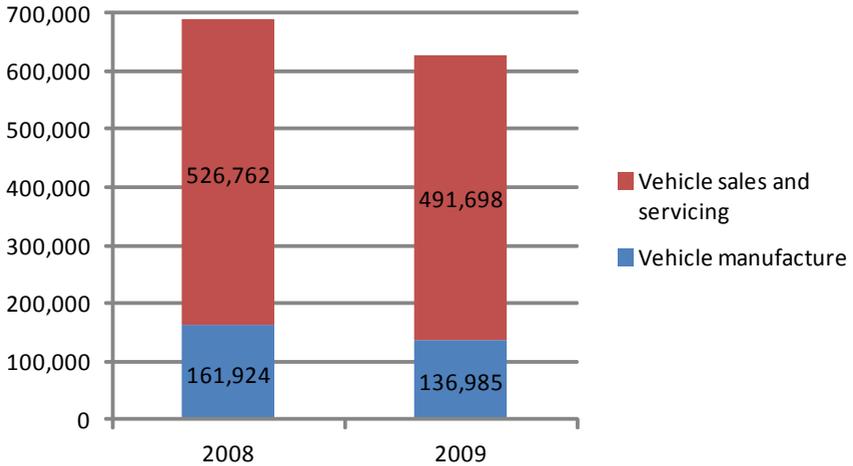
4. Automotive production is a key UK manufacturing sector

Despite the significant impact of the credit crunch and subsequent recession as well as ongoing industry consolidation, the wider automotive sector in Great Britain still employed 629,000 people in 2009. However, reflecting the economic slowdown the automotive sector shrank by 9% between 2008 and 2009, with 60,000 jobs shed from a workforce of 689,000 (2008). With the loss of just under 25,000 jobs (-15.4%) the vehicle manufacture sector was hit hardest. A further 35,000 jobs were lost in the larger vehicle sales and service sector (-6.7%).

Despite these recent job losses the wider automotive sector has an above average

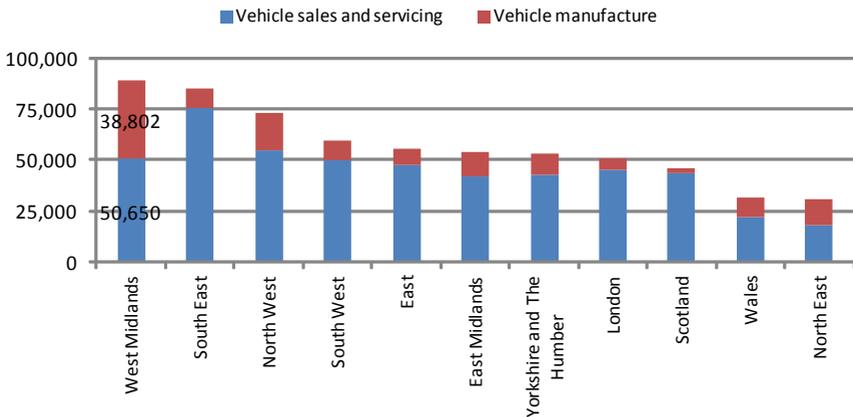
² BIS *Manufacturing in the UK: An economic analysis* (December 2010)

Figure 1: Wider Automotive Sector in GB: Employment (2008-2009)



Source: ONS BRES 2009. Employment = employees + working proprietors. Working Proprietors are sole traders, sole proprietors, partners and directors. This does not apply to registered charities

Figure 2: Wider Automotive Sector by GB Region: Employment (2009)



Source: ONS BRES 2009. Employment = employees + working proprietors. Working Proprietors are sole traders, sole proprietors, partners and directors. This does not apply to registered charities

importance in a number of regional and local economies in England. For example, the sector provides just under 89,500 jobs in the West Midlands, about 4% of all jobs in the region.

As the SMMT³ has identified the automotive industry is a vital part of the UK economy due to its export performance, the presence of global car manufacturers and Formula One teams in the UK and levels of Research & Development (R&D).

Each year the UK automotive sector produces over one million cars and commercial vehicles as well as over two million engines. This contributes over 10% of total UK exports and has delivered an average annual export value of more than £25bn over the last five years. With exports to over 100 markets worldwide the sector contributes around £8.5bn added value to the economy. In 2010 some 75% of the vehicles manufactured in the UK were exported. The manufacturing of vehicles provided 137,000 jobs, more than 6% of all manufacturing jobs in Great Britain.

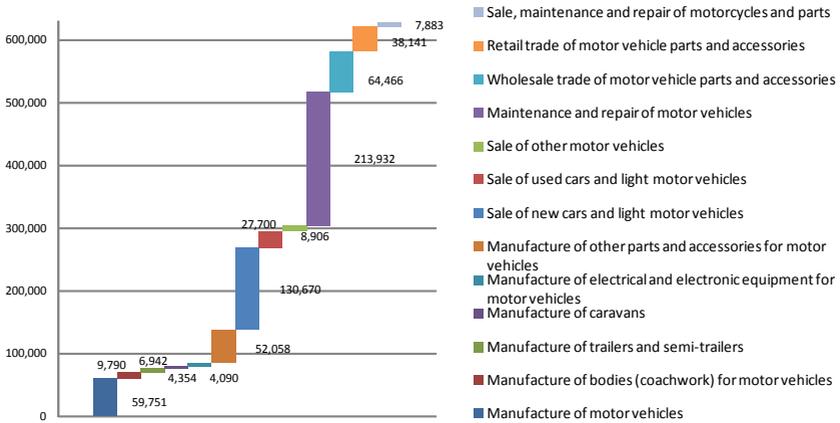
The UK is home to seven volume car manufacturers (including Nissan, Mini, Jaguar Land Rover, Honda and Toyota) and eight commercial vehicle manufacturers (including Vauxhall, Ford, Leyland Trucks, Land Rover, Alexander Dennis), has the largest number of specialist sports car manufacturers in the world and 19 of the world's top 20 automotive suppliers. The UK also has eight Formula One teams, supported by more than 300 specialist motorsport companies. This sector employs nearly 50,000 people in 'motorsport valley', a sectoral cluster centred on Oxford.

The automotive sector spends over £1.5bn annually on R&D in the UK and strategic government support for the transition to low carbon will continue to support over 700,000 jobs in the UK that rely on automotive manufacturing. In 2009, UK R&D investment in automobile and parts grew by 9%. The sector has also been successfully reducing emissions. Average new car CO₂ emissions have fallen by more than 20% in the last 10 years to reach 144.2g/km CO₂.

The economic impact of the vehicle production sector is much wider and embraces an extensive supply chain as well as a significant sales and service network. While there were 137,000 vehicle manufacturing jobs in Great Britain in 2009, there were a further 491,700 jobs in vehicle sales and servicing in England, at a crude ratio of 1 manufacturing job for every 3.6 jobs in the sales and service network.

3 The Society for Motor Manufacturers and Traders (SMMT) *Motor Industry Facts 2011*

Figure 3: Wider Automotive Sales and Service Sector in GB (2009)



Source: ONS BRES 2009. Employment = employees + working proprietors. Working Proprietors are sole traders, sole proprietors, partners and directors. This does not apply to registered charities

5. The UK has sectoral strengths in innovative automotive production

Earlier work⁴ has identified the strengths of the UK automotive industry as a diverse presence of major vehicle manufacturer owners from Europe, Japan, Malaysia, China, Kuwait, India and the US; labour flexibility; productivity; good scale for internal combustion engines (ICEs) manufacture; globally competitive vehicle and power train R&D; and strong premium brands, second only to Germany in global market share.

As BIS noted in 2010:

the UK automotive industry's existing strengths in world-leading premium and high-end vehicle manufacture, including light-weighting aluminium technologies, are being reinforced by a growing expertise in ultra low carbon and related technologies. This is evidenced by the UK's recent success in attracting a series of major groundbreaking low carbon investments by global automotive companies, including: Nissan's decision to build Europe's first mass market electric car (the Leaf) in Sunderland; the manufacture of the hybrid Toyota Auris and engine in the UK (the first hybrid engine to be built outside Japan); and Ford's £1.55bn investment in new low carbon engine projects at Dagenham and Bridgend.⁵

4 New Automotive Innovation and Growth Team (NAIGT) *An Independent Report into the Future of the Automotive Industry in the UK* (2008)

5 BIS *Manufacturing in the UK: An economic analysis* (December 2010)

However a number of weaknesses were also identified, including the lack of any global volume vehicle manufacturers headquartered in the UK; the lack of critical scale for vehicle manufacture (1.7 million in the UK versus 4 million+ in France, Germany and Japan); a shortage of sufficiently skilled workers (for both shop floor and R&D); the lack of an adequate supply base forcing some vehicle manufacturers and all global Tier 1 suppliers to limit their activities in the UK to just final assembly operations while relying on foreign R&D and component development and manufacture⁶; historically high interest rates and strong currency mitigating against export profitability; a lack of orchestrated collaboration among manufacturers and Tier 1 suppliers in the UK; Government ambivalence towards the automotive sector; and the absence of a consistent long term strategic policy framework for the sector.

While Government interest in the sector has been increasing as a consequence of the recession, it is still markedly different in scale and scope from the response common in other European countries. For example, in the UK's car scrappage scheme which operated from May 2009 until March 2010 up to £400 million of support was provided by the Government to scrap up to 400,000 vehicles with matched support from vehicle manufacturers. In contrast the German Government's £4.4 billion scheme which encouraged two million motorists to scrap their cars was five times larger. In addition, the German Kurzarbeitergeld scheme (reduced-hours compensation) provided Government subsidies for automotive (and other sector) staff taking temporary part-time working due to economic reasons. The affected employees were compensated by the federal government by up to 60% of their net salary (67% if childcare was involved) for up to 24 months.

These weaknesses aside, there are a number of reasons to be more rather than less optimistic about the future potential of the UK's automotive sector.

6. Market conditions and investment intentions are improving

Encouragingly the first half of 2011 has seen a number of investment and production announcements reconfirming the relative durability and importance of the automotive production sector in the UK. In total these involve the creation of 4,500 new jobs, investments worth £2.5 billion and production plans for six new models.⁷ These have included MG's decision to produce the MG6 GT at Longbridge, Birmingham (safeguarding 400 jobs), Jaguar Land Rover's plans for £490 million investment in its Solihull manufacturing plant to build the C-X75 all-hybrid supercar using 85% UK

⁶ Toyota recently announced that it is planning to manufacture key components for its hybrid cars outside Japan in China for the first time, in a bid to boost sales (5 September 2011).

⁷ SMMT *Automotive Manufacturing News Release 4915* (16 June 2011)

sourced parts⁸ (creating 4,500 jobs), Nissan's £192 million investment to build the new Qashqai in the UK with 43% UK sourced parts (safeguarding 6,000 jobs) and BMW Group's planned investment in its plants in Oxford, Birmingham and Swindon. Jaguar recently announced plans to build a new engine plant on the i54 business park in Wolverhampton which a short time ago was designated as an Enterprise Zone (18 September 2011). This investment of £355 million is expected to support the creation of around 750 new jobs in the area. Overall this suggests that the relatively buoyant automotive sector can offer real opportunities to be a key plank of the Government's rebalancing policy. However, there is some concern that capacity constraints in the UK supplier base may mean the downstream economic benefits of these investments could be lost.⁹

7. Potential to expand the UK supply base

The Automotive Council¹⁰ has investigated the potential to grow the UK supply chain and concluded that about 80% of all component types required for vehicle assembly operations can be produced by UK suppliers. This market is substantial. The combined UK purchasing spend of the UK-based automotive, commercial vehicle and yellow goods¹¹ manufacturers is £7.4bn per annum. The amount purchased in the UK equates to just 36% of their global purchasing spend demonstrating significant scope for expansion. With its particular geography, there would be important local and regional economic and employment impacts from an expansion of the UK automotive supply chain.

8. The UK can leverage the benefits of proximity

On average 74% of UK-based suppliers manufacture in the UK though this falls to 65% for Tier 1 suppliers (65%) and increases for Tier 2 suppliers where virtually all have UK based manufacturing facilities. Proximity was seen as the key competitive advantage of UK suppliers. Proximity reduces logistics cost and allows the responsive configuration of parts, as well as allowing for more flexibility to adjust to fluctuations in volumes and product mix. Proximity also reduces risk in the supply chain and acts as a hedge against currency fluctuations.

9. Supply chains are changing

Car production lines are now impressive advanced operations where a car which

8 Jaguar Land Rover is generally regarded as having the most UK orientated supply chain of any car manufacturer in the UK

9 When UK supply business is lost, the Automotive Council has estimated that about one third stays within the UK and Western Europe, one third goes to low-cost countries, while the final third show no clear pattern. The risk of losing business to low-cost regions rises however considerably for second tier suppliers.

10 Automotive Council *Growing the Automotive Supply Chain* (March 2011)

11 Yellow goods include construction and earth moving equipment, quarrying equipment, and fork lift trucks plus tractors.

comprises 20,000 to 25,000 components is assembled in about four hours. A near faultless supply chain is necessary to achieve this. However, the automotive sector also tends to be very cyclical which requires a very rapid response from its suppliers. Purchasing policy can change relatively quickly with major implications for UK suppliers, such as switching to suppliers in lower cost locations.

However, the original factors that made it so conducive to move manufacturing production overseas are changing.¹² Between 2003 and 2008 the price of crude oil doubled increasing shipping costs. Annual wage inflation in China averaged 19% between 2003 and 2008. Furthermore, some commentators are now suggesting that the existing supply chains, developed to manage stable high-volume production and based in low cost countries, are less well suited to a future characterised by rising global uncertainty¹³ and increasing business complexity.¹⁴ The Japanese earthquake and associated tsunami on 11 March 2011 brought into stark relief the risks from having a geographical concentration of suppliers. As a result the relative attractiveness of alternative manufacturing locations can change rapidly. On the flip side, many of these low cost locations in emerging economies are themselves now expanding markets for car and vehicle sales.¹⁵

10. Unit costs still remain the overriding competitive issue

The Automotive Council found that from discussions with purchasing directors at all seven volume car manufacturers in the UK, that the key reason why UK suppliers have lost business is that their unit cost was not competitive. Other reasons for not sourcing from UK suppliers were the general lack of accredited suppliers, the required processing capabilities that were not available and quality and logistics that were not seen as competitive. As well as operational performance, financial issues were found to be affecting UK suppliers detrimentally (e.g. availability of finance, concerns over supplier size and stability). As a result the study concluded that suppliers need to make their case on a total cost rather than unit cost basis.

11. Quality Standards must be achieved to supply major car manufacturers

Suppliers need to achieve high quality standards to supply a major car manufacturer.

12 McKinsey Quarterly *A Time to Rethink Offshoring* (Winter 2008)

13 In 2009 China's car market grew by 50% and by 30% in 2010 but this growth is forecast to fall to 1% in 2011 due to limits on new car sales and increasing inflation.

14 McKinsey Quarterly *Building the Supply Chain of the Future* (January 2011)

15 Premium models are in high demand especially to China. The global sales of the Porsche Cayenne more than doubled between January and June 2011 to hit 28,405 units and were the main constituent of Porsche's 47% sales increase in China.

TS16949¹⁶ is often required to supply a major car production line and a complete quality management infrastructure is required as a result (e.g. a dedicated Quality Manager). Many smaller suppliers just operate with ISO 9001. One automotive supplier estimated that it would take 5-7 years for a small firm to successfully secure a contract to supply a large car manufacturer with a new technology, partly reflecting the time and effort required to put in place the necessary quality management systems.

12. A roadmap of supply opportunities have been identified

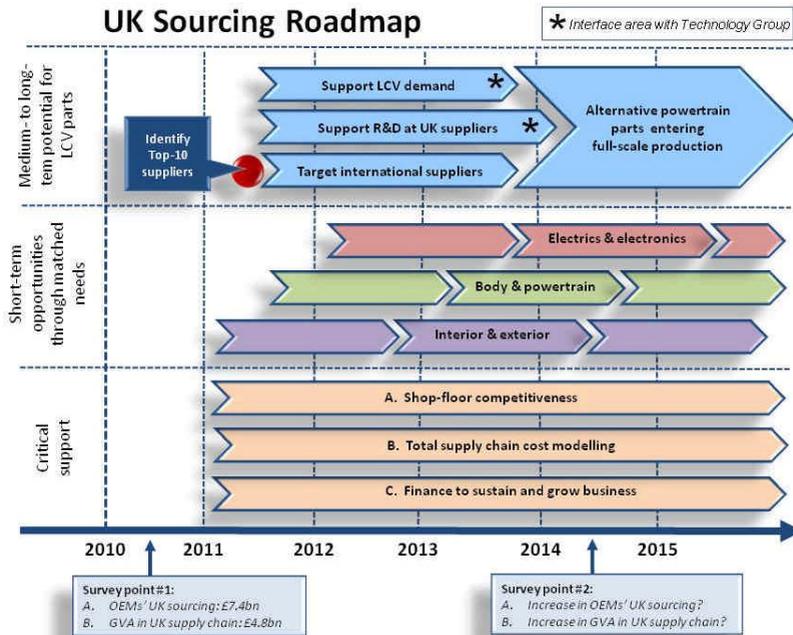
The Automotive Council study developed a UK Sourcing Roadmap which outlined the opportunities for retaining and developing automotive supply chain capabilities in the UK. Short-term opportunities were identified where a car manufacturer has a current need that can be met from a UK supplier. These include powertrain and body components, interior and exterior components and electrics and electronic components. Longer-term supply opportunities were identified in the shift towards a portfolio of powertrain architectures and their associated components. While these opportunities leverage proximity benefits, there is a need to understand how the supply chain operates and whether finance is adequate to have a realistic view of their potential.

13. Relationships and structures in the UK automotive supply chain

While identifying the main automotive manufacturers and Tier 1 suppliers is relatively easy, the interviewees spoken to as part of this study all thought it became much more difficult to plot the UK supply chain in detail from Tier 2 downwards. Many Tier 1 suppliers are located relatively near to the car manufacturing plants and have very close working relationships with the car manufacturer. The example of the plastic injection moulding sector (see box insert on pages 12 and 13) describes in more detail one part of the automotive supply chain.

As a consequence it is difficult, for example, to have a clear picture where Jaguar Land Rover's planned investment is going beyond the known Tier 1 suppliers. This makes it difficult to assess the spin-off and multiplier effects and, therefore, any actions required to fully leverage them. Even organisations such as the Manufacturing Advisory Service in the West Midlands which works with the client base on a regional

¹⁶ The ISO/TS16949 is an ISO technical specification that provides for continual improvement, emphasizing defect prevention and the reduction of variation and waste in the supply chain. It applies to the design/development, production and, when relevant, installation and servicing of automotive-related products and aims to harmonize country-specific regulations for Quality-Management-Systems. However the larger Asian car manufacturers often operate their own quality management systems for their corporate group and suppliers.



Source: Holweg, M *Growing the Automotive Supply Chain - The Road Forward* (Automotive Council UK, 2011)

basis admit they only have a partial view of the supplier base. While business networking events can help to attract suppliers many smaller firms do not attend due to time constraints.

As a result, it is difficult to engage with the sector holistically and the strengths of the supply chain are not fully understood or celebrated (e.g. innovative automotive products created in the UK by SMEs). Supplier firms noted that there is much more potential to present a positive picture of UK automotive firms, their suppliers and their heartlands (e.g. West Midlands, Wales and the North East). For example, Toyota's plant at Burnaston and Nissan's at Sunderland are renowned as some of the best car production plants in Europe. For the first time, cars produced by Toyota in the UK have been exported back to Japan and Nissan's Juke is the first car that has been fully developed outside Japan. Significant technical advancements seem to be taken for granted such as the doubling of fuel efficiency from 30 mpg to 60 mpg.

The main car manufacturers tend to be large international firms with HQs outside the UK

(e.g. in the USA, Japan and Germany). Their UK based plants do have a degree of operational and purchasing autonomy though this varies by company. This autonomy is growing as the UK becomes a stronger base for manufacturing. However, the suppliers we spoke to sensed that the volume car manufacturers are 'frightened of engagement' with the smaller suppliers. A number of whom in the West Midlands are currently developing innovative products such as electric vehicles components and battery management systems.

Supply Chain Structure: The UK automotive plastic injection moulding supply base

Plastic trim forms a substantial part of the interior shape, function, style and finish of the modern car cabin. Increasing the proportion of plastic components has been one way of reducing the weight of vehicles and improving their efficiency. The cosmetic nature of the parts and the logistical demands of Just-in-Time (JIT) manufacturing mean that these components are in the main all moulded within the UK. While often viewed as a commodity by the volume vehicle manufacturers, the suppliers need to have excellent competencies in tooling and JIT processes.

The UK automotive injection moulding supply base comprises several international Tier 1 suppliers with full access to the capital markets and about 20 to 25 small and medium sized firms. Some firms have been established in the UK for many years, originally serving Ford, the Rover Group, Jaguar and General Motors, and others developed new facilities to support the Japanese vehicle manufacturers who arrived in the UK from the late 1980s onwards. Most automotive plastic parts suppliers have a direct supply relationship with the vehicle manufacturer especially when parts are mounted directly onto the body in white and when the parts provide the interior and exterior finished style of the vehicle.

Large complex plastic assemblies such as bumper systems, instrument cockpits and front end modules tend to be supplied by large multinational Tier 1 system supply groups such as Magna, Toyoda Gosei and IAC Group GmbH, all of which have their HQ outside the UK.

Several firms, some of which are also part of international groups, serve the market for interior trim components:

- Hashimoto Limited
- R-Tek Limited
- Sanko Gosei Limited
- Maier UK Limited (Maier SD CoOp, Spain)
- Magna Limited (Magna Inc, Canada)
- Mollertech Ltd (Moller Group KG, Germany)
- Mecaplast Peterlee Ltd (Mecaplast SA, France)

- Bourbon Fabi UK Limited (Bourbon SA, France)
- Rosti Technical Plastics (UK) Ltd (AP Moller-Maersk AS, Denmark)
- McKechnie Engineered Plastics Limited (Melrose plc)
- WH Smith & Sons (Tools) Ltd
- Birkby's Plastics Limited

14. Automotive suppliers have specific operational issues

While it is difficult to generalise about a typical automotive supplier our research suggests that they are likely to have some or all of the following characteristics:

- **Run by engineers.** Many suppliers are run by engineers who, by their own admission, tend to be most interested in 'making things', and often have more of a secondary interest in finance.
- **High overheads.** The firms will often have high overheads and will be leasing their building.
- **Weak balance sheet and highly leveraged.** The firms require significant capital to run their business. Machinery is often purchased on lease finance that requires a positive cashflow, good D&B score and a certain level of turnover. Working capital is often secured from asset based lending from the debtor book and/or use of invoice discounting which requires a predictable sales pattern.
- **Tight margins.** The firms tend to operate to tight margins and high levels of operating efficiency are required.
- **Narrow customer base.** The firms themselves often have both a relatively narrow supplier base and a narrow customer base (to Tier 1 or 2 suppliers). Earlier work by the Automotive Council found that the median number of customers served by a supplier was six. As a result the firms often need to diversify their business risk in terms of both their customers and their sector.¹⁷ Automotive suppliers often supply other sectors with both similar and different products (e.g. aerospace, medical) (see example of RDM Automotive below).
- **High tooling costs.** The costs of tooling for new model programs are high. Suppliers are increasingly expected to finance tooling programs from internal resources which puts smaller suppliers reliant on bank financing for investment at a disadvantage. Banks have in general not regarded the manufacture of client specific tooling as being fundable through traditional loan finance instruments.

¹⁷ Following the collapse of MG Rover many supplier firms which were too dependent on one client and one sector have diversified their business risk by focussing more on the aerospace, defence and medical sectors. This approach was supported by Advantage West Midlands and MAS West Midlands through the Accelerate programme which has now ceased. The Accelerate programme was able to offer small capital grants alongside support for growth and business improvements. The ability to offer financial support helped to reassure external financiers.

- **Traditional banking.** The firms tend to rely on traditional banking for finance rather than equities, commercial paper or rights issues.
- **High new product costs.** New products may require significant R&D investments but have uncertain payback periods.
- **Difficulty scaling up.** Automotive suppliers can have problems scaling up to volume production even if they have a new innovative product. Often the only solution is to sell or licence the Intellectual Property (IP) to a Tier 1 supplier who can meet the demands of a volume manufacturer like Ford.
- **Verbal rather than written orders.** Suppliers are often asked to complete one off and low volume orders on a verbal basis which is problematic if additional finance is required to fulfil the order. A written order is generally required by a bank as part of any loan application.
- **Cashflow strain.** Suppliers report that their financial terms are now being stretched from 30 to 60 or 90 days resulting in 'cashflow strain'. There was some evidence that an increasing number of smaller automotive suppliers are being paid late.
- **Family run.** Suppliers are often family run enterprises with a need for active succession planning.
- **Coping with rapidly rising energy costs and commodity costs.** An injection moulding firm employing 112 people with an annual turnover of £6.8 million saw the costs of its raw material inputs increase from 42% of costs in 2010 to 44.5% in 2011. At the same time their energy bill rose by 15%.

Case Study: RDM Automotive / Leacy MG

Established 19 years ago and based in Coventry, RDM Automotive employs about 30 people and has a turnover of £4 million. RDM has a strategy of growth by acquisition and by diversification as well as organic growth. Their success is directly related to car sales and the expansion of one of their main customers, Jaguar Land Rover. They have also been able to weather the recession and be in a position to take up slack in the market. Despite their relatively small size, RDM is a full service Tier 1 supplier that designs, develops and manufactures niche automotive components for Jaguar Land Rover, Bentley and Aston Martin as well as operating as a Tier 2 supplier. RDM has a small to medium volume output of multiple products (e.g. wiring harnesses, electronic control modules, plastic and metal parts) as well as involvement in the development of electrical and hydrogen fuelled vehicles. RDM has a wide range of suppliers with many being sourced from the West Midlands.

Operationally, RDM has to be fast and flexible to respond to their customers and able to accept the 'difficult' jobs. While predominantly automotive, RDM also produced

telemetry products (e.g. for monitoring the drivers of 300 electrical vehicles on recent TSB funded trials) and has been developing a medical products line that is near to launch.

In April 2011 RDM bought Leacy MG which supplies classic car parts for MGs, Healeys, Minis and Triumphs, and has a turnover of £2.5 million. From an inventory of 22,000 parts, the Birmingham based firm ships car parts worldwide and is starting to design and manufacture parts that are no longer produced. The ambition is to double the turnover of Leacy MG in three years.

15. Financing the automotive supply chain

The operational nature of automotive suppliers in turn affects their use of and access to finance. Automotive suppliers and their advisers interviewed as part of this study identified a number of specific financial issues which they regard as both problematic and limiting their future growth potential. They included:

- **Historic stigma is slow to change.** Many suppliers operate in an industry that is viewed sceptically by the finance sector due the legacy of financial stress events over the last 30 years. However, suppliers were concerned that some banks were operating on the basis of out of date perceptions and past stigma about the sector. For example it was reported that some banks remain wary about lending to the suppliers of Jaguar Land Rover (JLR) despite its recent investment announcements. Low credit scores for volume car manufacturers and Tier 1 suppliers can have the effect of capping the level of invoice discounting that a supplier will be permitted by a bank. Firms felt that banks needed to update their sectoral understanding far more frequently.
- **Sectoral preference of banks.** Firms felt that banks should be clear about which sectors they were interested in lending to so a supplier could target specific banks. Automotive suppliers would like to know which banks are truly 'open for business' with the automotive sector. There remains a high level of cynicism about the banks which are not helped by some financial horror stories.¹⁸
- **Unnecessary paperwork.** Firms highlighted as problematic the need to complete identical paperwork for applications to each bank and were unclear why it is not possible to have a central repository where the same data is entered just once.
- **Slow decision times.** Decisions on finance are required quickly by automotive

¹⁸ For example, one respondent reported that a North London motor dealer, despite trading successfully since 1912, had just one year of losses and this led to additional interest charges and management fees imposed by their bank with little consideration.

suppliers. For example, a 27 person automotive supplier in the West Midlands needed to raise £500,000 to finance three new machines in just 12 weeks, the lead time for production. Suppliers would like to see a Charter for an agreed response time for bank loan applications and decisions as it directly impacts on the ability of automotive suppliers to take on new business.

- **Cost of reviews.** Suppliers objected strongly to having to pay very expensive fees (£10,000 to £20,000) to third parties (e.g. consultants) to review their applications for extended loan facilities. This is not viewed as a positive process by suppliers especially when funding is turned down.
- **Costs and terms of finance.** About five years ago an automotive supplier could borrow at about 2% over base rate, now it is 10% over base rate. This is, of course, partly driven by the banks needing to rebuild their balance sheets in line with Government legislation.
- **Feedback from loan applications.** Firms felt that banks failed to communicate credit scoring approaches and provide detailed and actionable feedback when a loan application was rejected.
- **Personal guarantees.** Personal guarantees are greatly disliked as a security by automotive suppliers, especially for businesses that exist as their own distinct legal entity.
- **Evidence requirements.** Suppliers noted issues around the different evidence of order values that their customers will provide (verbal order) and what banks will accept as part of a loan application (written order).
- **Invoice discounting.** Invoice discounting is a form of short-term borrowing which is often used to improve a firm's working capital and cash flow position. Invoice discounting allows a business to draw down money against its sales invoices before the customer has actually paid. To do this, the firm borrows a percentage of the value of its sales ledger/invoices from a bank or finance company. The bank will charge a monthly fee for the service as well as interest on the amount borrowed against sales invoices. In addition, the bank may refuse to lend against some invoices if, for example, it believes the customer is a credit risk. Automotive suppliers felt that they were being forced down a more expensive invoice discounting route rather than being able to access traditional loans. A number of suppliers reported that invoice discounting did not suit a volatile industry and much greater flexibility and understanding was required by the banks. If suppliers breached invoice discounting limits the funds were not provided but the firms were still charged the associated fees by their bank.
- **Switching problems.** Some firms reported problems when transferring accounts between banks (e.g. a failure to close mortgages which have been transferred between banks had triggered problems with their credit scoring).

Case study: how a loan application from an automotive supplier would be assessed

A typical loan application process generally involves the following steps:

- Bank originator would work with the firm to produce the funding application.
- The type of funding requested would vary with its use (e.g. purchasing of supplies, working capital, tooling of manufacturing plant)
- A range of due diligence and credit scoring exercises are undertaken to assess the application for finance. Specialist technical and financial advice is sometimes required to consider various issues (e.g. feasibility, third party company review).
- As well as considering default risks and the bank's lending policies, the application may also be assessed against the bank's balance sheet liquidity requirements.
- For larger firms, their relationship with the bank can be key to securing funding as, if they are well known to the bank, it can take an holistic view of their business.

Most of the major banks assess the following issues when considering an application for finance.

1. Character
2. Capability
3. Capital
4. Purpose
5. Amount
6. Repayment
7. Terms
8. Security

As well as corporate credit policies that outline a bank's appetite for lending to a sector or asset class, computerised credit scores tend to be key to assessing a loan application, even for relatively large sums. The assessment process often varies for different application values (e.g. up to £50 million, £50 to £200 million and >£200 million). A Group level committee or credit committee would only be used for very large loans. In reality individuals at different levels in a bank have discretion to lend up to certain thresholds on both secured and unsecured bases. For example, a local bank manager may be able to lend up to £500,000 on a secured basis.

16. Many of these financial issues are not new

The financial issues identified by the case study firms and industry representatives broadly resonate with the findings outlined in other reports into financial lending to business in the UK. The Rowlands Report¹⁹ investigated the availability of growth capital for SMEs in the UK and found a permanent gap in the provision of growth capital. It concluded that each year up to 5,000 viable SMEs that are growing or restructuring are likely to experience significant problems in accessing capital as the economy emerges from recession.

The Rowlands Report went on to identify a number of reasons why there is gap in the supply of growth capital to small and medium firms in the UK, and these issues will apply equally to smaller automotive suppliers. First, there were structural market failures which applied more widely to the supply of capital to SMEs. Imperfect information means that both the firm and the investor or bank have insufficient information to make the best investment decision. Compared to larger deals there are high costs in researching information about smaller firms. There is also often much less financial performance data for smaller firms. Many firms were not seen as investment ready, lacking in knowledge about the potential of equity finance and were overly focussed on debt as the sole finance option. Many owners were often not willing to give up a stake in their business in return for equity finance.

Second, there were a number of market issues that applied specifically to the supply of growth capital. Private equity has a preference for larger deals where risk is easier to assess. Financial incentives for fund managers tend to encourage investment in larger transactions. Financial institutions often limit the proportion of funds they will allocate to 'alternative assets' which include private equity and venture capital investment.

And finally, the impact of the financial crisis and recession. Until recently, banks would extend traditional short term or working capital debt finance to an increased range of purposes, including growth. Since the credit crunch banks have retreated into more traditional lending practices possibly reflecting increased risk aversion.

17. Banks engagement with the automotive supply chain

Banks primarily segregate their customers by size of turnover rather than on an explicit supply chain basis. For example RBS's business and commercial customers are classified as having a turnover of less than £25 million and corporate customers a turnover of more than £25 million. RBS then further segregates their corporate clients on an activity basis between car retail (franchise, non-franchise and the so called 'after market' like Halfords), car manufacturers and their supply chain; and car rental operations. Overall a bank is

¹⁹ The Rowlands Report *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* (November 2009)

unlikely to have an integrated picture of its customer base across an industry supply chain especially for the smaller firms involved.

The major car manufacturers and larger global suppliers will have specific financial needs and substantial in-house capabilities. The large global car manufacturers will be handled by the global services department of major banks. Large Tier 1 automotive suppliers such as GKN and Bosch are quoted companies with sophisticated in-house treasury functions, access to international capital markets and the ability to undertake rights issues²⁰ to raise finance.

For smaller firms, their main bank contact point is often a relationship manager who may be responsible for managing around 90 accounts. While some automotive suppliers are active in developing these relationships, others are less so. However, smaller firms reported wide variations in the level of understanding of the automotive sector amongst relationship managers. Overall there appears to be less understanding of firms with turnovers below £25 million and, in aggregate, these firms can be significant. For example, in the UK there are 120 smaller volume car manufacturers²¹ whose current and planned production (if it comes to fruition could reach 300,000 cars).

Banks will identify very clear asset classes for investment and set investment and credit policy on this basis (e.g. automotive, infrastructure, media and manufacturing). Banks will also have different appetites for lending to certain sectors. However, there are likely to be operational benefits for a bank if they are able to take a more holistic supply chain view of their customer base. Interviews with banking representatives suggested that having an improved understanding of the automotive sector and its supply chain connections would be beneficial to their operations, customer service and understanding of risk.

18. Way Forward

Drawing from existing background research and discussions with a number of suppliers and banking representatives, this study concludes that there are a number of areas where suppliers, banks and the public sector can work together to support the expansion of the automotive supply chain in the UK.

²⁰ GKN announced a £423 million rights issue in June 2009 as a £350m revolving credit facility was to expire in 2010. Talks with banks about replacing it indicated that the company would have to accept high interest charges and "onerous" covenants. The rights issue was used to pay down debt and for working capital and investment as the company aimed to gain market share from struggling rivals.

²¹ With about 100 members the Niche Vehicle Network (NVN) is characterized by low volume production, specialized components, bespoke body and chassis and (in the case of sports cars) a significant proportion of hand-built or hand-finished parts companies.

Banks could improve their sectoral understanding. Banks and the automotive industry are not as well engaged with each other as they could be. The automotive sector could have a better reputation and relationship with the banking sector. Historically there have been many instances of financial stress in the sector, shorthand for business failures, which colour the judgement of financial organisations.

Improved intelligence for banks would help to develop their understanding of sectoral opportunities and issues from 'top to bottom' (e.g. understanding product cycles, delivery schedules). For a bank, a better constructed and performing portfolio of investments and loans would help to further improve the bank's appetite for lending to the sector. As an example of positive development, RBS created a new automotive focussed role (Head of Automotive) which previously did not exist. Increasing the range of automotive specialists working with finance staff within a bank would improve understanding of the dynamics of the industry. There would be potential to notice industry challenges at an early stage and to be more able to consider the impacts across all their customers in the automotive supply chain. There is also the potential for credit policy on risk to become more sophisticated and for some underlying assumptions and financial processes to be challenged and discussed.

- **More detailed and structured dialogue between the banks and the automotive suppliers (especially Tier 2 downwards) to discuss ways to improve mutual understanding of key financial issues.**

Supply chain mapping required. The automotive supply chain is relatively complex, volatile and, given the commercial data involved, secretive. The banks themselves suggested that they would value a better understanding of the supply chain to improve their services, risk management and strategy and policy development. Even public sector agencies such as the Manufacturing Advisory Service in the West Midlands admitted that their understanding of the automotive supply chain is partial and comes mainly from personal contacts. However, the volume car manufacturers will have completed a thorough due diligence exercise on their suppliers and with open book accounting and detailed day-to-day contact they will have a good knowledge of a supplier.

- **There is need to undertake supply chain mapping in more detail to understand relationships, including their financial importance.**

UK's Automotive Council could focus more on smaller suppliers. The establishment of the UK Automotive Council is generally regarded as a good idea and was acknowledged as doing a good job despite being in its infancy. Two years ago there was

very little understanding of the UK automotive industry in Government and a more co-ordinated approach to promoting Britain's automotive business is welcome. It plays an important ambassadorial role to help the industry make its case. While engagement with the manufacturers and Tier 1 suppliers has been good, it was suggested that the Automotive Council had yet to substantially engage with Tier 2 and 3 suppliers.

- **The Automotive Council could explore ways to engage with the small automotive suppliers in the UK with a specific focus on their financial issues.**

With the abolition of Regional Development Agencies the more private sector led Local Economic Partnerships have yet to champion the automotive sector in key regional and local areas. The wider automotive sector remains especially important to a number of regional economies like the West Midlands. However, with the abolition of Regional Development Agencies (RDAs) and the uncertainty surrounding Business Link, the range of support and public funded financial options available to the automotive supply chain has been greatly reduced. While the regionally based Manufacturing Advisory Service provides some support, this is limited and the service is currently being retendered with a more standardised service planned from 2012 onwards. There is just one person who specialises on the automotive sector in the MAS for the whole of the West Midlands – an area which has suffered disproportionately from unemployment in the current recession and still has 39,000 automotive workers.

While the emerging Local Economic Partnerships (LEPs) in the West Midlands may have a focus on the automotive sector in the future there are a number of issues to overcome. First, the former area of Advantage West Midlands is now covered by five different LEPs increasing the challenge of achieving a joined-up approach. Second, LEPs will have much less funding to support the automotive sector regionally. Third, LEPs will have limited numbers of permanent staff and are only emerging slowly as organisations. And finally, while some of the LEPs in the West Midlands have retained a focus on finance issues for business, it is reported that events now are very generic and dominated by bank representatives.

- **The Automotive Council and others should consider what action is required at a regional and local level to support the sector and smaller suppliers in addition to current national level initiatives.**

Technology Strategy Board (TSB) was noted as being important in funding research and development into electric vehicles and their systems (e.g. battery management systems). However, the Accelerate programme which was operated by Advantage West

Midlands and MAS West Midlands provided relatively small grants (around £20,000) which helped to engage smaller firms in innovation as well as reassuring external financiers. In contrast TSB bids, which tend to be much larger (e.g. £9 million over 5 projects), require substantial partnering efforts and involves more paperwork. All together this tends to put off smaller firms. In the West Midlands, the Niche Vehicle Network (NVN) has had to bid as the lead body for a £500,000 TSB project which will then be split between 5 projects, each with 4-6 partners to ensure the involvement of the smaller, innovative automotive firms from across the region.

- **The Technology Strategy Board could be more focussed on engaging smaller firms.**

Other financial options could be developed and/or promoted. Some respondents highlighted that other financial options such as Research and Development (R&D) tax credits and, where applicable, Community Development Finance Institutions (CDFIs)²² could be used more widely and promoted more actively to automotive suppliers (e.g. through accountants who often do not know of their existence). Development can include relocation costs for the business which can easily reach £100,000.

- **Wider promotion of full range of financial options for automotive suppliers.**

Image of the sector. Concerns with the image and perception of the automotive manufacturing sector, especially to young people, was a recurrent concern of interviewees. While Formula One is well known by young people it is often seen as a different world from the volume car manufacturers and their suppliers which, while now a relatively high technology sector, is not perceived as such. With GKN as UK's only quoted automotive supplier the sector does not have a high visibility to young people and, to a certain extent, also to the financial sector.

- **There is a need to raise the profile of the sector to young people (for example by working with the careers service) and promote the pride of making modern vehicles using very advanced processes and components.**

Skills and training. A number of firms highlighted deficiencies in the skills of young

²² Community Development Finance Institutions (CDFIs) lend money to businesses, social enterprises and individuals who struggle to get finance from high street banks and loan companies. They help deprived communities by offering loans and support at an affordable rate to people who cannot access credit elsewhere. Those operating in the West Midlands are members of the Fair Finance Consortium (www.fair-finance.net). These more flexible loans tend to be capped at a maximum of around £50,000 but can have relatively expensive borrowing costs of 10% to 13%.

people and an approach to training which remains too supply driven. A factory floor worker in a small or medium sized automotive supplier will require a good attendance discipline, competent reading and basic maths for quality assurance. Each new model can often require new training of the production workforce and their supplier workforce. Training in the UK was felt to be over specified through the NVQ frameworks and established provider models. Firms felt it was too early to say whether the new apprenticeship model is helping to address these issues but some good practice examples exist, such as at Gateshead College and Nissan.²³ Some firms also felt there was scope to learn from Europe (e.g. the ability to offset training spending against tax).

➤ **Is there scope for more flexibility in training for automotive suppliers?**

Broaden the SMMT to embrace financial issues. Respondents reflected that while the SMMT tends to have a broad audience it may wish to see if it can segment its audiences further and expand the range of participants to those beyond the automotive sector (e.g. heads of banks, credit policy, corporate insurance, sector analysts) and work with other business and trade bodies on similar financial issues to prevent duplication (e.g. British Chambers of Commerce, Engineering Employers Federation, CBI, British Bankers Association).

➤ **To start to address the financial issues facing automotive suppliers the SMMT could broad its mix of stakeholders across sectors and seek to engage more smaller firms.**

²³ Since opening the Automotive Centre of Excellence in 2005, Gateshead College has formed a strong and productive partnership with Nissan in Sunderland. Based in the Team Valley, the £5.5 million building incorporates a complete training centre for Nissan apprentices, including simulated production lines, a rolling road for vehicle testing and specialist welding facilities. In February 2011 Nissan announced that a further 25 apprentices would be trained at Gateshead College. This will take the number of apprentices taken on at the Nissan plant to 1,058 since it was established in 1984.

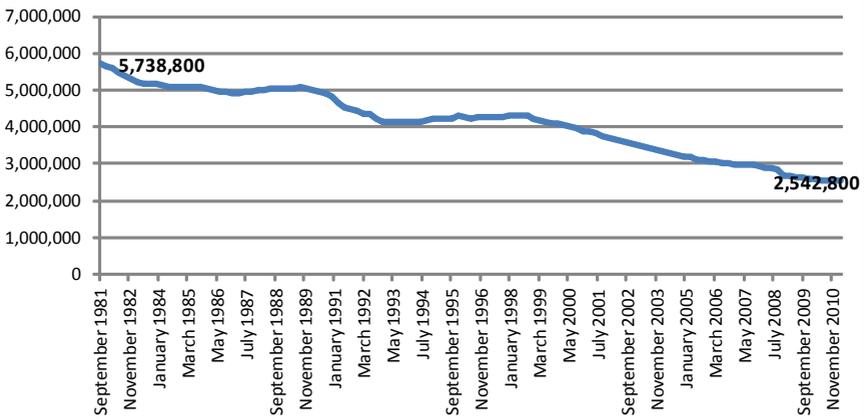
About the author

Andy Rumfitt is a Director of Innovation and Research Fellow at the Smith Institute. Andy specialises in the analysis of regional, urban and local economies and provides technical advice on business and sectoral development issues to clients from the public and private sectors.

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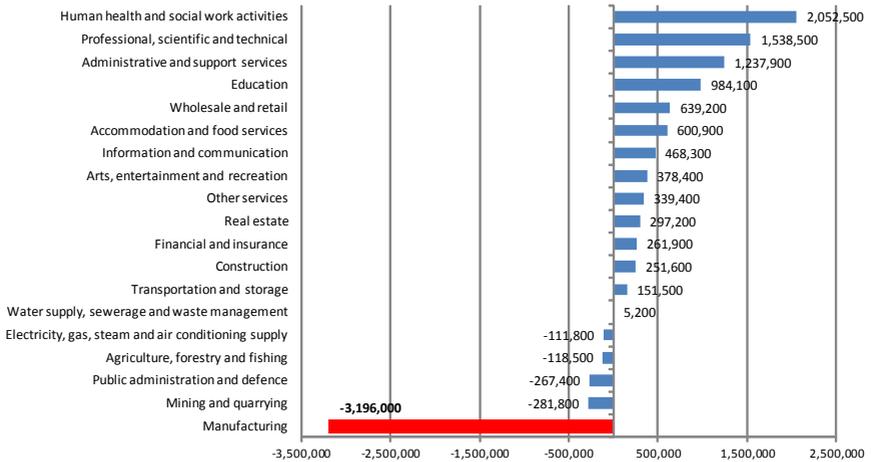
Annex

UK Manufacturing Employment (1981–2010)



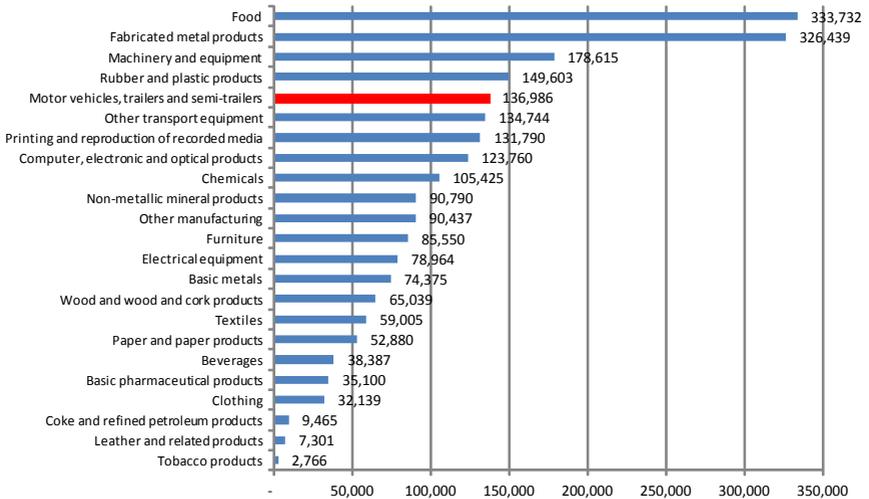
Source: ONS. Total workforce jobs. Workforce Jobs is a quarterly measure of the number of jobs in the UK and is the preferred measure of the change in jobs by industry.

UK Employment Change (1981–2010)



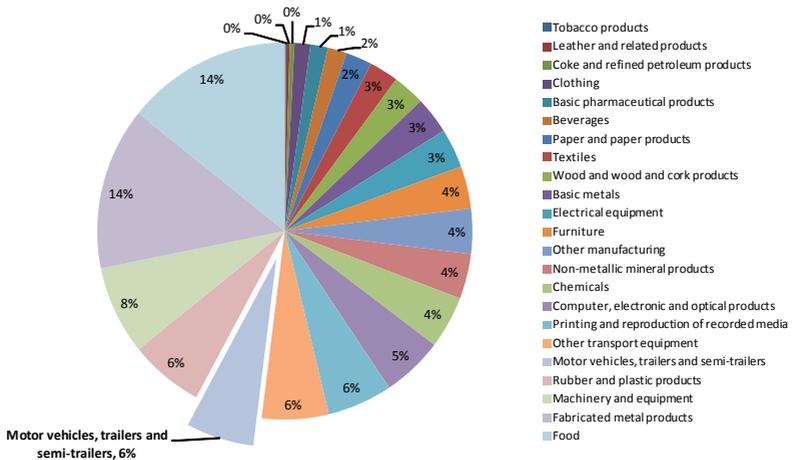
Source: ONS. Total workforce jobs. Workforce Jobs (WFJ) is a quarterly measure of the number of jobs in the UK and is the preferred measure of the change in jobs by industry.

GB Manufacturing Sectors: Employment (2009)



Source: ONS BRES 2009. 23 two digit manufacturing sectors. Employment = employees + working proprietors. Working Proprietors are sole traders, sole proprietors, partners and directors. This does not apply to registered charities.

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