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Central Europe as a focal point of the automotive industry

Deloitte study

2016

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It is my pleasure to present Deloitte's new survey of the Central European automotive industry, which presents the opinions of leaders of manufacturing and supply companies in the industry. The aim of the survey conducted in six countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia) is to describe the specific features of the sector in the region, as well as to show how the relevant companies see their positions.

The automotive market is constantly growing in the region and is recognised as a sector of increasing importance, as shown by the rate of investments. The survey clearly shows that despite the numerous external and internal risk factors, companies in Central Europe are positive about the future. In our discussions with leaders of 80 companies in the region we touch upon issues such as location related conditions, the local legal environment, grant opportunities, relationship between suppliers and manufacturers, and future plans of their companies.

Let me thank the representatives of companies involved in the survey for their time and contribution to the success of the survey. I hope that you will find this study an insightful and inspiring read.

Best regards,

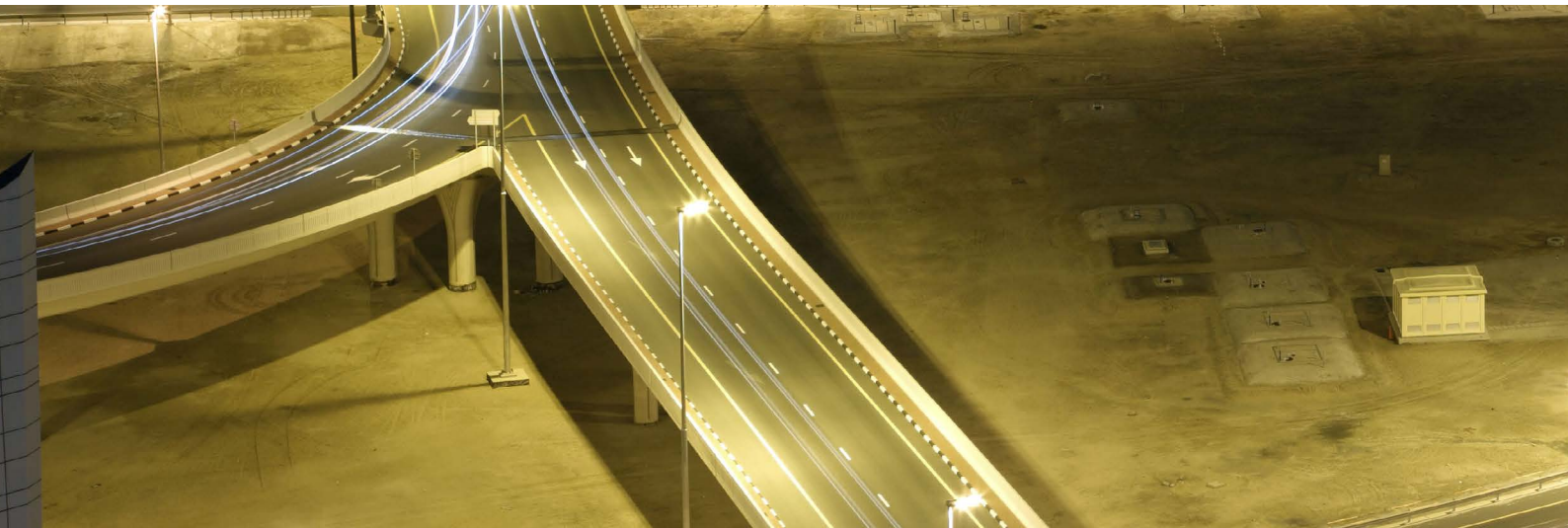
Péter Gerendási
Partner, Tax and Legal

I. Background

The importance of automotive factory locations in the European Union (hereinafter: EU) member states of Central Europe (hereinafter: CE) has steadily increased in recent years. Automotive facilities in Western Europe have been subject to closure and total employment has been reduced since 2009. However, employment opportunities have been partly re-established in CE countries, based on the fact that the previously closed factories have been relocated in the new EU member states. As a result of these changes, approximately one in three vehicles are produced within the following EU member states: the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. Based on manufactured vehicles per capita, Slovakia is the leading producer of vehicles with 180 units per thousand inhabitants, according to the industry association European Automobile Manufacturers' Association (hereinafter: ACEA). The Czech Republic ranks second with 108 vehicles and Germany third with 70 vehicles.

Deloitte conducted a survey, by means of questionnaires provided to executives at 8 automotive manufacturers and 72 supplier companies (hereinafter: companies) in Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. Questions were posed about the advantages and disadvantages of each country and the economic setting within the scope of automotive industry. The aim of the survey was to receive information about the following:

- Which location-related factors led to the CE automotive industry success story?
- How have the factors changed in recent years?
- What is the future vision of senior management of the manufacturers and suppliers?
- How can these countries become more competitive and attractive within the automotive industry?

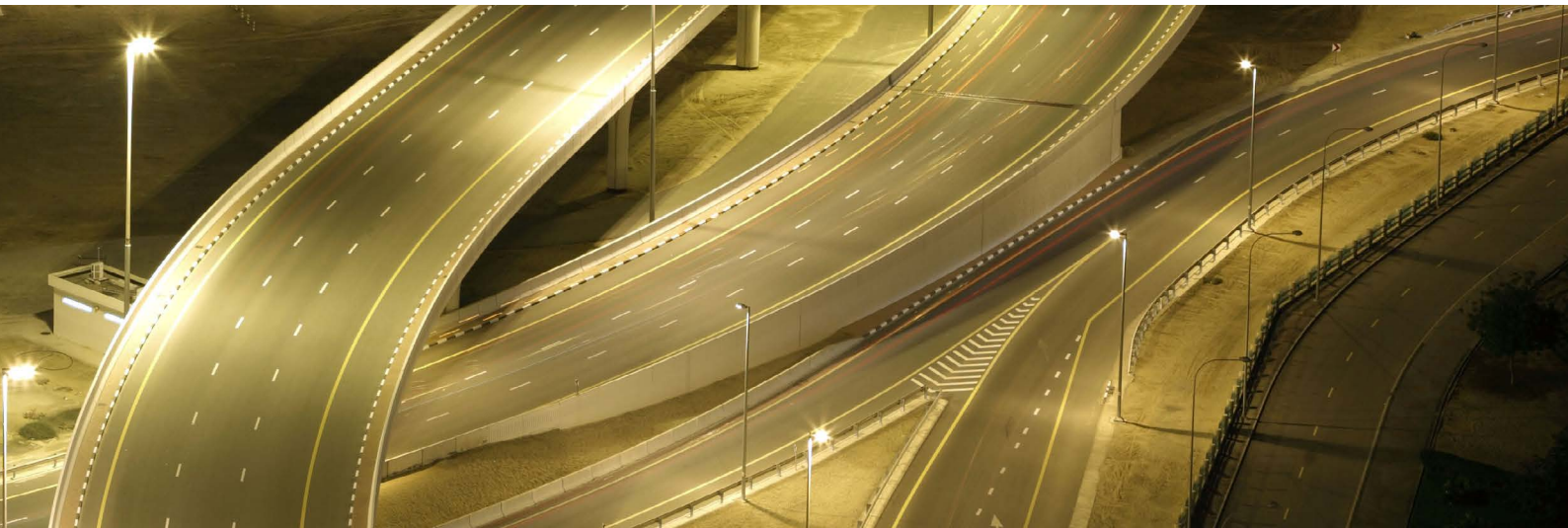


Number of participants in survey per country

Country	Supplier	Manufacturer	Total
Hungary	9	2	11
Poland	16	2	18
Czech Republic	19	3	22
Slovakia	7	0	7
Romania	6	1	7
Bulgaria	15	0	15
Total	72	8	80

The executives at the companies surveyed mentioned 3 areas as requiring urgent attention by the Government in each country: (1) reform in the eductional system and vocational training, (2) infrastructure improvement, (3) reliability of the legal system. In each of the countries surveyed, companies are planning to make additional investments and to increase their workforce. New technology is a key factor in the process, based on the rapidly increasing pace of innovation in CE. Many of the companies surveyed are convinced that the interconnectedness of traffic, the electrification of the powertrain and autonomous driving as well as Industry 4.0 will have an impact on their business in the near future. The respective companies are preparing for these trends in their short/medium term plans.

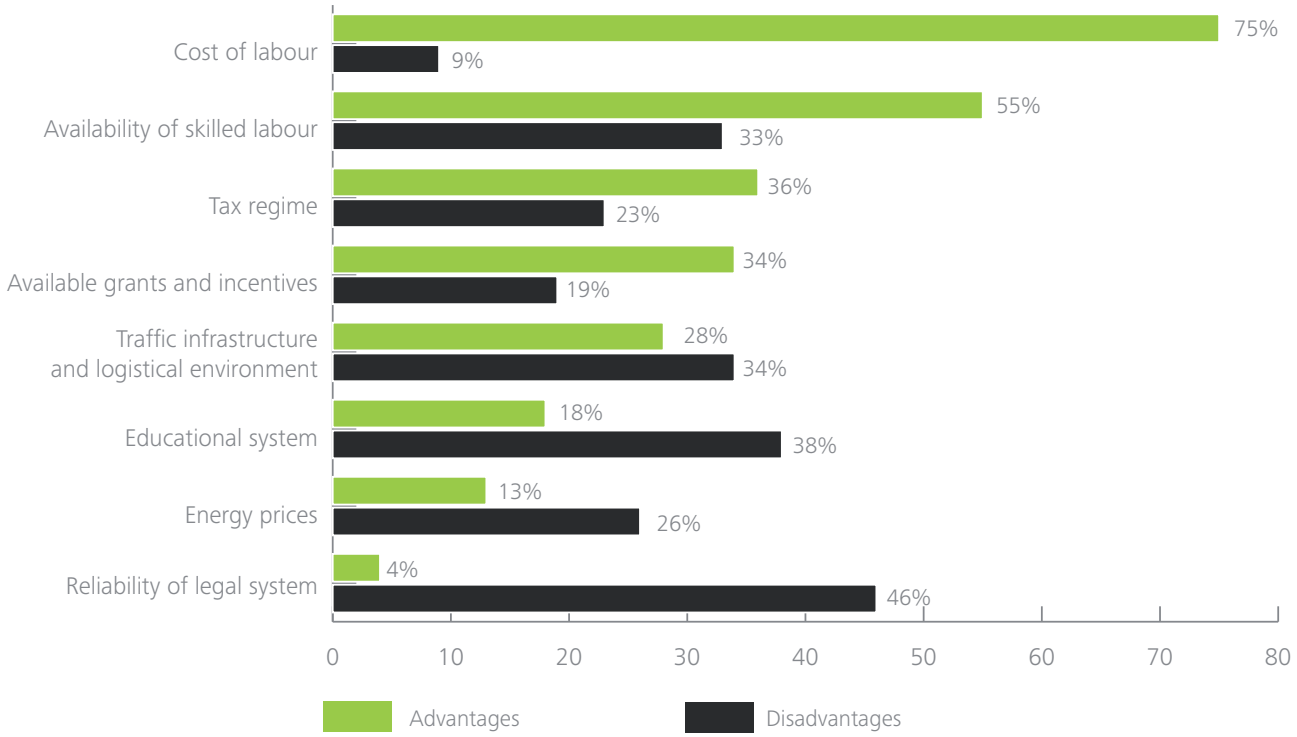
This survey was conducted during Q3 2015 prior to the deceleration of the growth rate in China. A further strengthening of the US-Dollar has favoured the export by European car manufacturers and their suppliers. In our opinion, these global developments do not compromise the results of our survey. Rather, it seems likely, that the above mentioned issues will serve to propel current trends at an increased pace.



II. Location factors

Location

Question 1: Which of the following location factors in your host country would you assess as three competitive advantages and which ones as three disadvantages?



The table above illustrates that there are several important reasons for companies to invest/operate in the countries surveyed. Please find below a brief list of the highest ranked beneficial factors:

- low labour costs,
- availability of skilled labour force,
- favourable tax regime.

However, there are also some negative aspects which require attention, such as:

- poor reliability of the legal system and remediation processes,
- poor/under developed educational systems,
- deficiencies in transport infrastructure.

Workforce and education

Three quarters of the executives surveyed consider low labour costs as an advantage of the locations in the CE region, while more than 50% of those interviewed consider the availability of skilled labour as an added benefit. However, here the perceptions are not consistent: eg. 33% of the interviewees consider the availability of qualified labour a disadvantage. Based on the information received, it appears that countries with high employment rates such as Slovakia and the Czech Republic are beginning to reflect increasing wages and growing scarcity of skilled labour. Csaba Wolf, business development director at Deloitte in Budapest commented: "When manufacturers and suppliers built their plants in CE it was relatively easy to find a sufficient number of skilled workers. However, this task is increasingly a challenge." In addition to the above, the companies' rising quality standards and the improved technology incorporated in their products and processes further increase the demand for skilled employees.

It is interesting to note that 38% of the respondents consider the educational systems within the surveyed CE countries to be a locational disadvantage, only 18% consider the educational systems to be an advantage. Consequently, investors will rightfully be concerned about the extent to which the academic education and vocational training provided in CE countries will impact the skilled labour force. Hungary, Poland and Slovakia show that they are improving the process of qualification in these areas.

Interview on the educational system in the Czech Republic

Bernard Bauer
Managing director,
German-Czech
Chamber of Industry
and Commerce

The German - Czech Chamber of Commerce recently conducted a survey on the investment climate in the Czech Republic, what were the major results with regard to professional education in the manufacturing industry?
First of all we have to state that 92% of the participants of our survey would invest in the Czech Republic again. This is a good message. But there is one aspect which threatens the competitiveness of the country. In our survey, the aspects 'quality of the Vocational and Educational Training (VET) system' and 'availability of skilled workers' were rated very low by the companies. Also, in these areas, the Czech Republic is rated among the worst of all countries in Central Europe. This is particularly alarming because the situation will deteriorate in the years to come if the VET system will not be reformed. This is the essential message that we draw from the results of our survey and which unfortunately confirms our concerns and political interventions in the past years.

What do you think is missing in the educational system of the Czech Republic, and in particular professional training?
What is missing in the educational system of the Czech Republic is an institutionalized cooperation between vocational schools and companies. There is a massive lack of practical training in the vocational education institutions, the facilities are outdated and so is the curriculum. Especially in the technical-industrial and partly also in the commercial sector, the vocational training no longer meets the demands of the labour market.

In order to meet the requirements of companies who invested in the manufacturing industry and who plan to stay, what do you recommend?
The companies investing in the Czech Republic have been complaining for many years about the lack of qualified vocational school graduates. In order for the Czech Republic to remain a competitive and attractive business location for investors, we recommend the implementation of a dual education system which combines apprenticeships at companies and vocational education at vocational schools. The public educational system and the companies have to co-operate.

Providing a VET system that prepares the students for the labour market is a direct investment in the competitiveness of the Czech Republic. We have therefore made this as one of our key topics of the German-Czech Chamber. Our message is clear: it is time to act now.

How does the situation in the Czech Republic compare to other countries in Central Europe?
If we look at other Central European countries such as Poland, Slovakia and Hungary, we see a similar situation to that of the Czech Republic with regard to the educational system. But they have already taken measures to better adapt their VET systems to the demands of the labour market.

Some countries, e.g. the Netherlands or Austria - those with by far the lowest youth unemployment in Europe - show with their training models how a successful educational system should work: The state holds the educational authority but delegates some of its powers to the companies. This is a model of shared responsibility for the vocational training. Poland and Hungary have already partly adapted this system. We are convinced that this system could work in the Czech Republic as well. The implementation of such a system of shared responsibility could guarantee the competitiveness of the Czech Republic for the future. The process of digitalization of the industry, which will increase with Industry 4.0, will raise new challenges and the demand for more qualified employees.

Tax regime, incentives and legal system

As mentioned earlier an efficient tax regime plays an important role in where manufacturers will choose to locate. Tax rates are generally lower in CE than in Western Europe, while the transparency of the applicable tax legislation leaves room for improvement. This may provide support as to why many of the respondents see the tax regimes in CE as being a disadvantage.

The impact of available grants and incentives in CE appears to have less of an impact on manufacturers' decisions regarding location choice. Slightly more than 33% of the respondents consider grants/incentives as a motivating factor. The above may confirm that factors such as the availability of skilled labour and an advantageous tax regime are more important drivers of investment decisions than grants and incentives. However, the role of incentives still has an impact when they are compared from country to country.

An important result of the survey was that 46% of the respondents commented on the poor reliability of the legal system in many countries as a major disadvantage. This is something we suggest the governments in CE look at closely in order to address this concern.

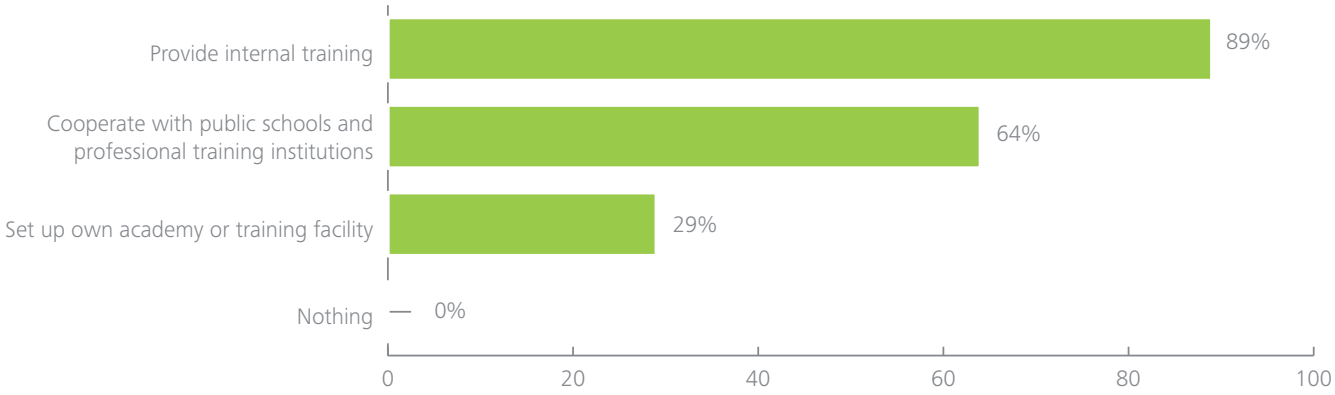
Infrastructure and energy

Traffic infrastructure and the logistics environment show a diverse result among the countries surveyed. Overall the region is perceived as being weak in this area by 34% of the respondents. The development levels of infrastructure facilities in the CE countries surveyed were impacted by geographical location, size and economic strength. According to the respondents Hungary and Slovakia yielded more positive results whereas the remaining CE countries showed a marked disadvantage in these areas. This is certainly a significant obstacle for the highly connected supply chains involved in the automotive sector where just-in-time delivery and security of supplies are necessary for the maintenance of effective assembly lines.

The responses related to the importance of energy prices do not reflect a clear trend. Respondents in Poland viewed energy prices as a disadvantage, while they see it as an advantage in Bulgaria. The national energy policies in place in the CE countries surveyed clearly influence the perception of a sector with a relatively high energy consumption rate.

Workforce qualification

Question 2: What measures have been taken to support the qualification of your workforce?

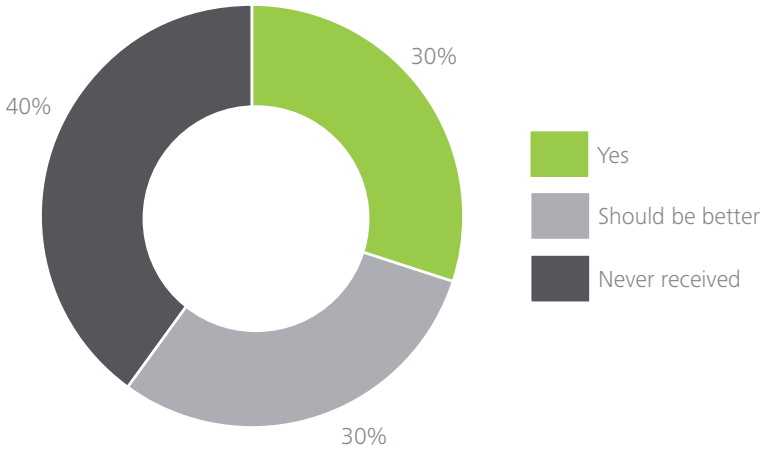


All of the companies within the CE countries that were surveyed are aware of the importance of providing education/training to ensure a skilled labour force. However, the companies surveyed varied in their responses to the measures taken to ensure the support and development of their employees. In Hungary and Slovakia, the focus is on increasing co-operation with public schools, providing internal training whilst developing company-owned academies are only a second or third priority. Companies in Bulgaria, the Czech Republic, Poland and Romania are relying primarily on internal training whilst vocational education.

Automotive manufacturers' expectations regarding vocational training are generally not being met in the CE countries surveyed. In addition, as a result of ever increasing expectations in technological progress and increasing global competition, employees also feel the pressure to improve their skills. Employers and employees must rely on their own ideas and initiative to improve the qualification and skills required for future success. Reforms to the public education system have become an urgent matter as companies try to maintain a competitive advantage. Imbalances between multi-national companies and small and mid-size companies may widen: multinationals are more willing to invest in internal training and academies, while small and mid-sized companies have fewer resources to finance training and consequently must draw from a less educated workforce.

Satisfaction with EU incentives

Question 3: Are you satisfied with EU incentives your company has received so far?

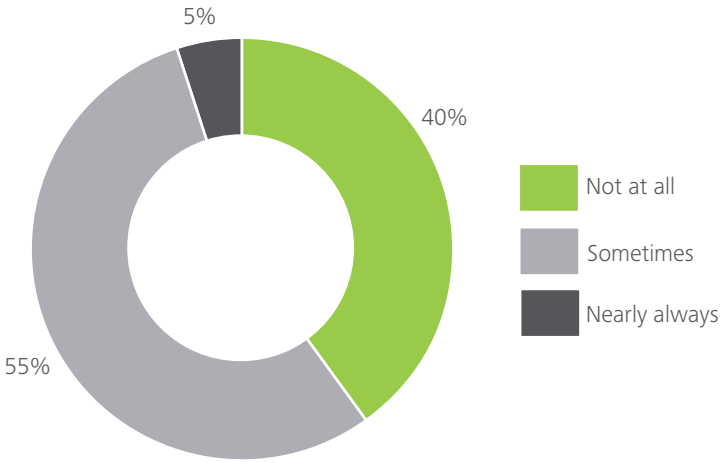


Satisfaction with European Union subsidies and grants tends to be quite varied based on the response of CE countries surveyed. 40% of the respondents have never received EU subsidies, while 30% are satisfied with what they have received so far. The remaining 30% responded that EU incentives could be improved in terms of both eligibility criteria and process.

According to Luděk Hanáček, Tax Partner responsible for grants and incentives at Deloitte in Prague, there are only limited subsidies available from EU funds for large investments frequently found in the automotive sector. However, the lack of EU funds for significant investments is often compensated by packages or incentives offered by local governments. EU funds are provided primarily for R&D and environmental projects. At a national level cash grants are often capped, as a result, investors prefer tax-related incentives with higher total benefits.

Corruption and business

Question 4: Do you think corruption influences business in your host country?



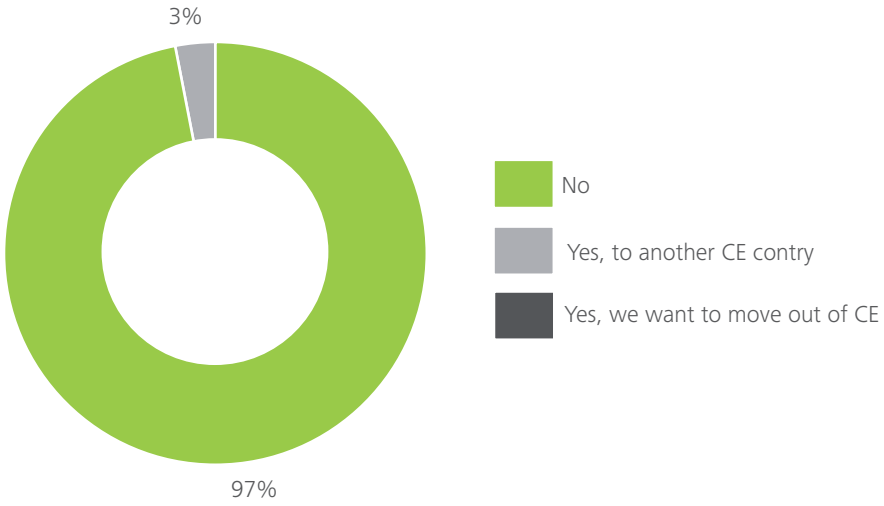
When conducting the interviews, most of the respondents agreed that corruption is present in their country. However, with regards to the automotive sector they did not feel directly affected or only to a lower degree. From comments, it appears that respondents affiliated with multinational companies tended to rely on the application of global anti-corruption policies ("zero tolerance"). However, in many instances especially at smaller local companies there appears to be a greater challenge when dealing with corruption.

Transparency International's latest survey (2015), which is related to all industries in the CE countries surveyed, shows Poland as being in 30th place. This puts the country in a comparatively good position. Other countries fared worse in this study: the Czech Republic (37), Hungary (50), Slovakia (50), Romania (58) and Bulgaria (69).

Source: https://www.transparency.org/cpi2015

Relocation of operations

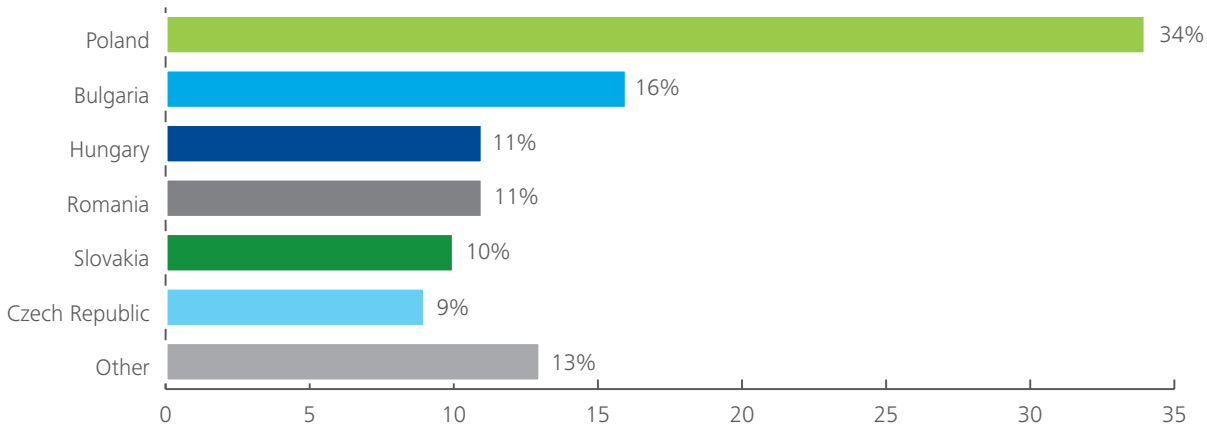
Question 5: Are you considering the relocation of your production facility in the next 5 years?



The question dealing with the potential relocation of operations received a clear response. Not one single company surveyed in Poland, Slovakia, Romania or Bulgaria is considering the relocation of its production facility to another country within the next five years. Only a very small percentage of companies in Hungary and the Czech Republic responded that they are considering relocating to another country in Central Europe. None of the companies surveyed is planning to relocate outside of Central Europe.

Preferred locations

Question 6: If you were to open a new branch of your company in Central Europe, which country would you choose?



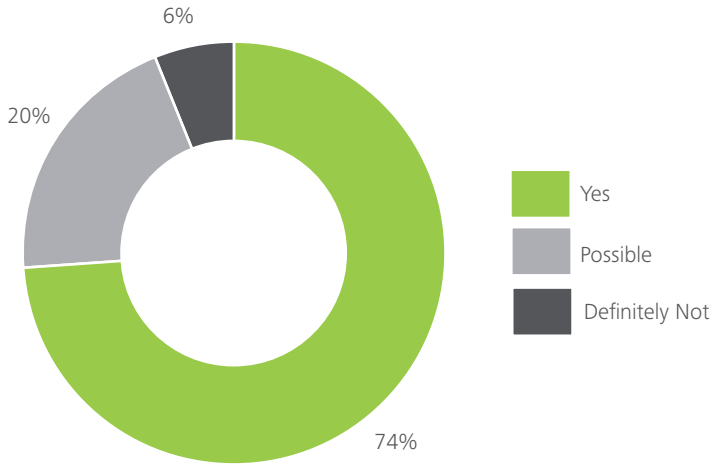
When asked about the preferred location for a new plant, a majority of respondents in Hungary, Poland, Romania and Bulgaria indicated their own country. In Poland, 100% of the executives surveyed would choose a new facility in their own country. In the Czech Republic and Slovakia, other CE countries were preferred sites for new facilities. In Slovakia, more than 50% of those surveyed preferred Poland as the location for a new facility. In turn, 23% of the respondents in the Czech Republic gave priority to Slovakia and Hungary.

These responses reflect a high degree of preference for current locations. Most of the executives surveyed preferred to remain in their current location. However, overall averages reflected a preference for Poland if new operations are established.

III. Investments and Growth

Production capacity

Question 7: Are you planning to increase your production capacity in the next 5 years?

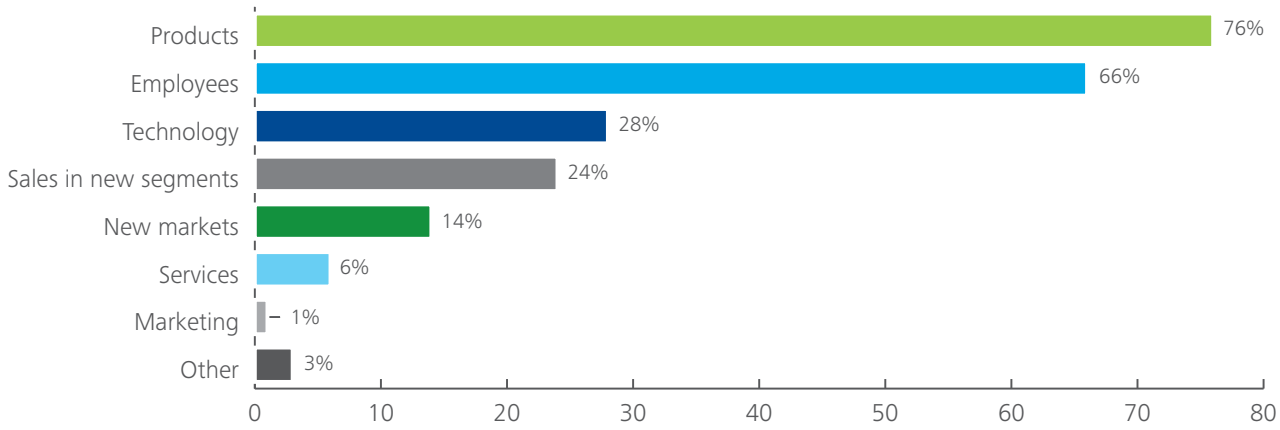


In response to the question, "Are you planning to expand your production capacity in the next five years?" a majority of the executives in each market participating in the study responded in the affirmative. 74% of the executives surveyed wished to increase their production capacity.

Bulgaria and Poland led the way with over 80% of executives planning to expand production and more than 10% indicated that expansion was a possibility. Hungary scored lowest in terms of expanding production, although 64% of the executives surveyed stated they would still like to expand their production capacity. This is clearly a very optimistic message for the CE region: the automotive sector has not yet reached its limits in terms of growth potential. The advantages offered by being located in CE will remain available in the foreseeable future, thus allowing for good positioning on the global automotive market.

Investment plans

Question 8: When planning a new investment in the next five years, which of the following factors are you planning to focus on/increase (up to three answers)?



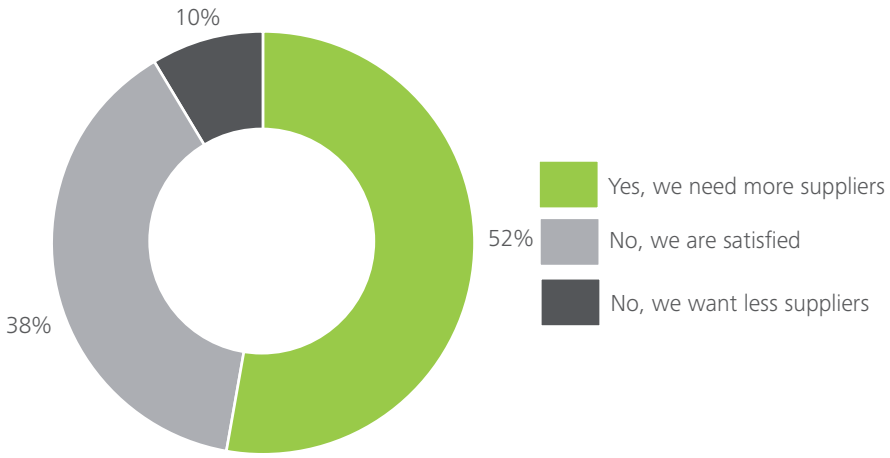
Over the next five years those surveyed intended to focus on the innovation of new products and educating a skilled labour force. Additionally the development of new technologies and the expansion of product lines into new segments were cited. However, it also appears that marketing has a rather limited role in future plans and executives did not cite this as a major area of focus. Investments in services and new markets also remained in the background. Such investment decisions are still reserved for the headquarters of the companies surveyed. "We are seeing the locations outgrowing their role as purely production facilities and they are increasingly taking on tasks in research and development or roles as technical competence centres", said Christoph Greving, Deloitte Partner responsible for German multinational clients in Central Europe based in Prague.

In all of the CE countries surveyed the areas of focus for new investments are subsidized to some degree by tax incentives. These incentives are usually granted to companies that commit to new investments of a certain value and/or to the creation of new jobs. "Investors should consider these opportunities and the respective conditions otherwise the incentives could be lost or tax position not properly utilised" said Tomasz Pałka, a Senior Manager and Tax Automotive Leader in Poland.

IV. Supplier - carmaker network and innovation

Supplier networks

Question 9: Are you planning to increase the number of suppliers in the next 5 years?

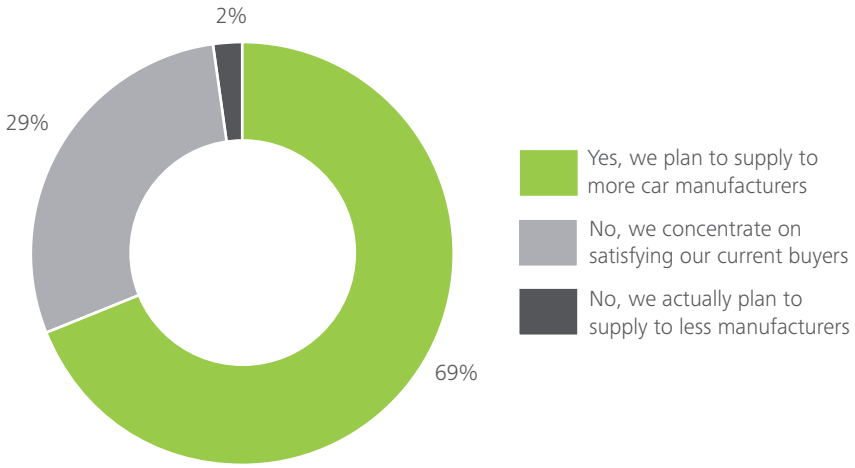


Within the CE countries surveyed no decisive pattern emerged as to whether the automotive companies intend to increase, reduce or maintain the number of suppliers they are currently cooperating with. Technology trends will significantly impact the direction of these companies. If electronic propulsion and/or connectivity become more popular, various new suppliers may also enter the market. These suppliers will conceivably introduce new electronic technologies and components.

Simultaneously, less technologically advanced suppliers may be forced out of the market. Brake and exhaust systems will be modernized, potentially very complex engines and systems may be sourced from only one or a few suppliers in the future. Such changes would reduce further the number of suppliers on the market. Furthermore, more cost efficient suppliers may gain entry into the industry in order to reduce the in house production depth and exploit outsourcing and specialization models.

Client portfolios of suppliers

Question 10: Are you planning to supply to more car manufacturers in the next 5 years? (only for suppliers)

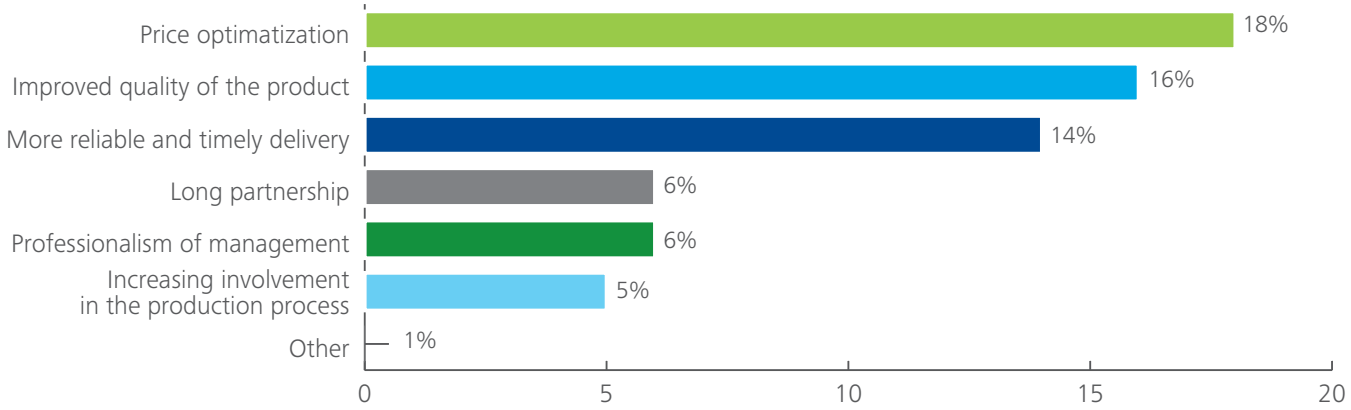


Within the CE countries surveyed nearly 70% of the automotive suppliers intend to expand their client portfolio (this percentage reaches 100% in Romania and Bulgaria).

Based on this trend it is clear that the search for new sales channels continues when suppliers are operating relatively new plants, and that CE automotive suppliers are internationalizing their clientele, the direction being the global market.

Manufacturers' expectations

Question 11: What are the car manufacturers' expectations towards their suppliers? (only car manufacturers, up to three answers)



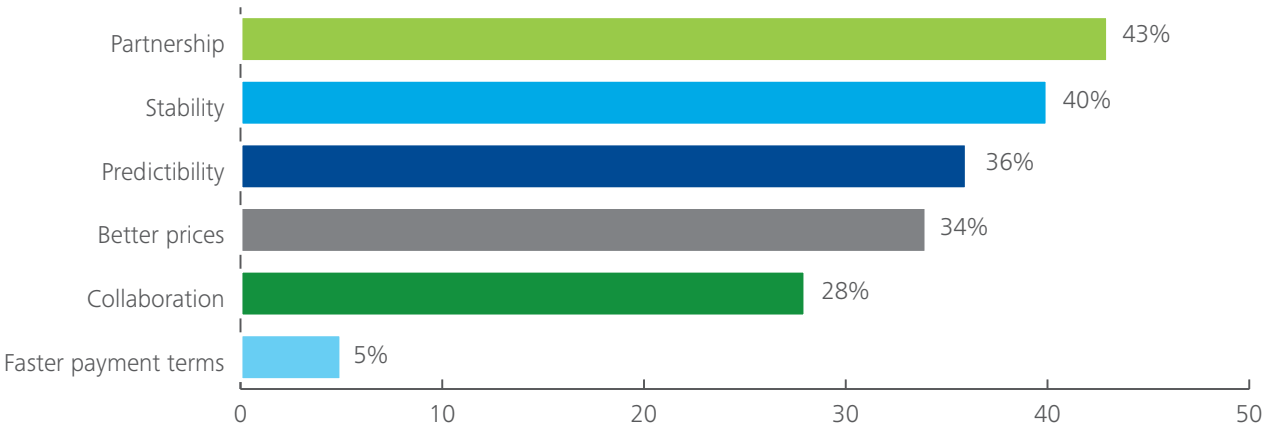
Optimization of price and quality ranked the highest in terms of expectations of manufacturers. This expectation was stable across all the countries surveyed in CE.

Reliability and timely delivery come before the need for long term partnership or more involvement in the production process.

Based on the interviews conducted, it appears that suppliers are not evaluated based on a single strength, rather they are expected to meet a set of requirements which are equally comprised of cost, quality and reliability of service. From the OEMs' perspective it is essential that the suppliers aim to comply with group-wide standardization strategies (platforms, identical parts and components, model kits) and quality requirements, e.g. by setting up world class manufacturing and quality management systems on the supplier side.

Suppliers' expectations

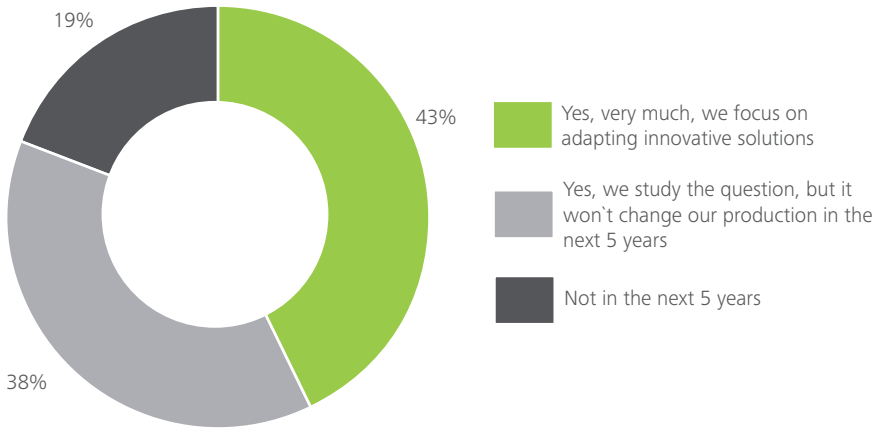
Question 12: What do you expect from the car manufacturers? (suppliers only, up to three answers)



Suppliers were also surveyed as regards their expectation from manufacturers. Stability and partnership ranked above higher prices. 34% of those surveyed indicated improved prices as an aim. However, only 5% requested increased speed of payment. Predictability of orders (36%) ranked higher than improved prices. Based on these results, it appears that the predictability of orders and the planning of production over a longer period is worth more to suppliers than other issues. "These results may also suggest that suppliers are required to have flexible production facilities to meet the "just-in-time" expectations of car manufacturers in our constantly changing world" said Marek Turczyński, Deloitte Partner and Automotive Leader in Poland.

Innovation

Question 13: Do ongoing innovation topics (such as electric cars, connectivity, autonomous driving etc.) have an impact on your business in the next 5 years?



The manufacturers and suppliers taking part in the survey indicated that innovation and new technologies such as connectivity, electric cars and autonomous driving are playing an increasing role. 43% of all respondents in the region indicated that they are focusing on the application of new technological solutions. More than 50% of respondents in Bulgaria, Hungary and Romania reflected this trend. Other areas of focus stated in the interviews were: e.g. inter-active parts (brake pads to cockpit), car-to-car communication, driver assistance components, supercharging and storage systems.

More than 50% of the respondents indicated that they are not expecting production changes over the next five years due to evolving product innovations. However, this does not imply that 50% of the participants are not taking into consideration the technology trends arising in the automotive sector. On the contrary, many of the participants expect that trends such as Industry 4.0 will shortly impact their production processes, e.g. by means of connected assembly lines. Weight reduction and the use of new materials such as carbon fibres is another important topic. Some of our respondents commented that they are highly aligned with their headquarters regarding the development and time of application of new technologies.

Conclusions

Based on the results of our survey it appears that the automotive industry is satisfied with the location-related conditions in CE and does not intend to relocate for cost or other purposes. It also became evident that the companies based in CE countries require improvement or change in various areas in order to optimize their activities in order to remain competitive. The supply of skilled labour is tightening in well-developed countries. In the Czech Republic and Slovakia, for a majority of surveyed companies the lack of supply of skilled labour was seen as a major negative factor for the automotive industry.

Improvement is also required in the area of legislation. Respondents expressed concern about the reliability of the legal system in various countries. Additionally, corruption was cited as an issue, although its actual impact on the automotive sector is difficult to ascertain. The respective tax regime of the CE countries surveyed also received some criticism. Lack of transparency seemed to cause more concern than the actual levels of taxation.

The importance of grants in investment decisions is often overstated. Companies consider the country's general and long-term conditions to be more important in terms of achieving success.

The satisfaction and loyalty of the companies surveyed with their current locations are notably high. The companies' investment plans also supported the fact that they are largely satisfied with their current location. A substantial majority of the companies' surveyed plan to expand capacity over the next five years, produce new products and hire staff – even in countries where this is becoming increasingly difficult. The current facilities are thus outgrowing their past role as extended workbenches for standardized, mass-produced products. Innovation and technology are becoming increasingly important to both manufacturers and suppliers. Suppliers that are preparing for this challenge can expect above-average growth in the future.

Currently the relationship between suppliers and manufacturers is decreasingly driven by price and cost pressures than it was a decade ago. OEMs and their suppliers are increasingly aiming for partnership, the joint development of new technologies, on-time deliveries and long-term business relationships.

Overall, based on the responses received from our CE survey it appears that both medium and long-term prospects for the automotive industry in Central Europe are good. The investment plans of the CE companies surveyed and their internationalization of customer relationships provide ample reason for optimism regarding the future of the automotive industry in Central Europe.

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