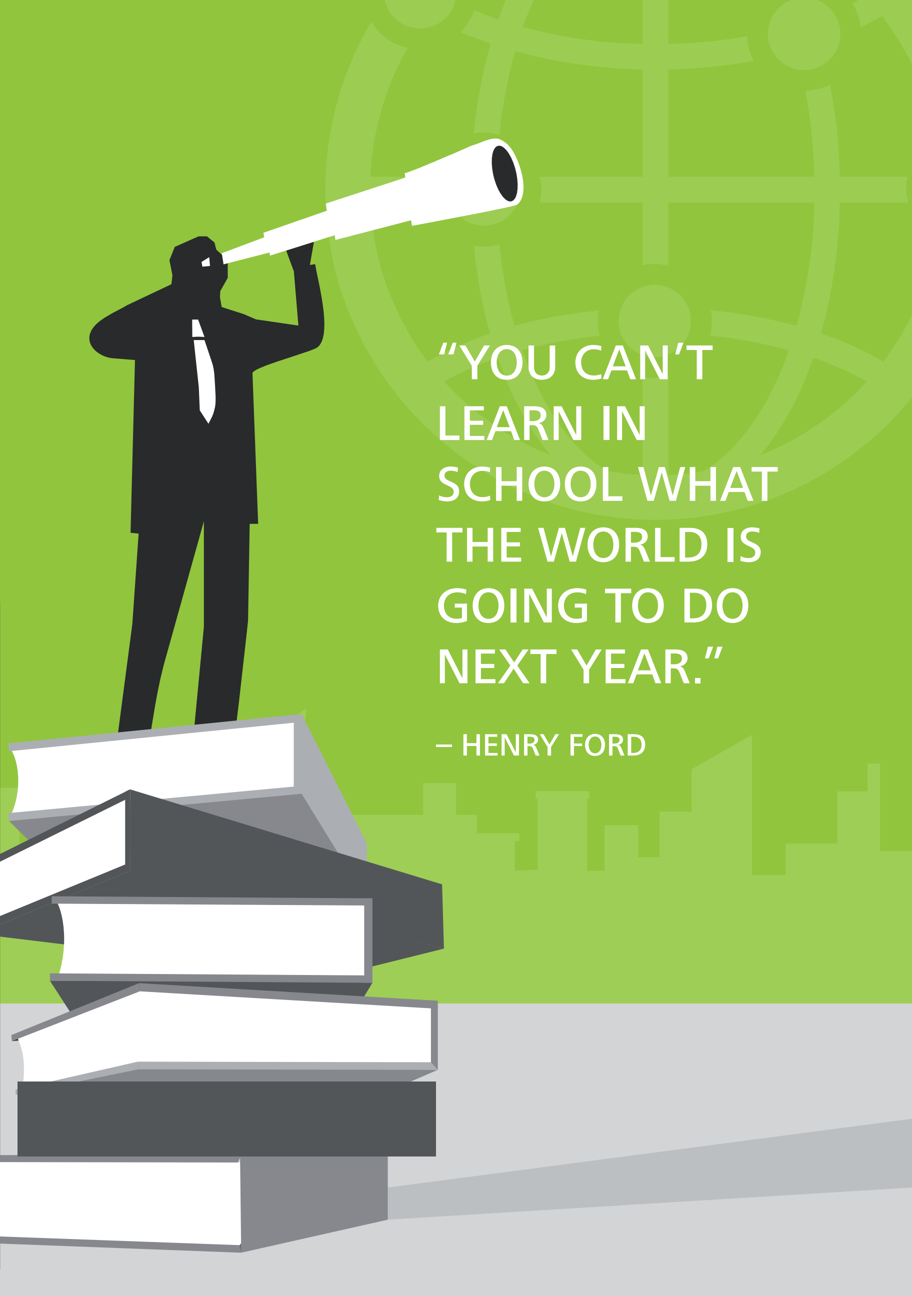
DISRUPT

AUTOMOTIVE SUPPLY BASE

Deloitte *on...*

DISRUPTION

IN THE AUTOMOTIVE SUPPLY BASE


"YOU CAN'T LEARN IN SCHOOL WHAT THE WORLD IS GOING TO DO NEXT YEAR."
– HENRY FORD

Sharpening the Focus on Strategic Risk

Continued globalization. Financial crises and bankruptcies. Natural disasters. Social media. Shareholder activism and board responsibility. Increasing fuel economy standards. Highly integrated supply chains. Major quality issues and recalls. Electrification. Connected vehicles.

The beginning of the 21st century has already seen its share of "low likelihood" events. Pile on government, regulatory, and industry-led initiatives to transform the automotive industry and align it with evolving customer preferences and technology innovations, and the current environment is filled with significant business risks–and opportunities. How well-prepared is your business strategy to address this–and the future–environment? What are the risks to your current business plans and assumptions? How effective are your competitors at managing the opportunities and risks?

Strategic risks are the ones that threaten to disrupt the very assumptions at the core of a company's strategy… not just the execution of the strategy.

This steady flow of marketplace disruptions demands predictive, adaptive, and thoughtful capabilities and responses. Suppliers can adapt to the level of disruption by changing their approach to risk management–moving beyond traditional enterprise risk management (ERM) to opportunity-seeking strategic risk management (SRM).

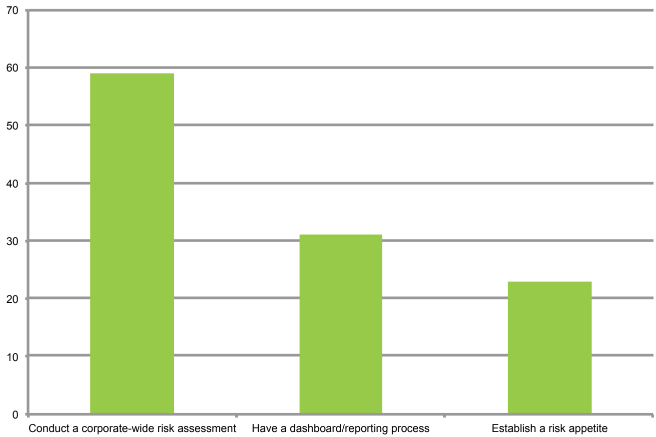
Automotive suppliers that get risk "right" and embed SRM principles across the enterprise–will likely be more competitive, more profitable, and face lower probabilities of major recalls or other major consequences that could bring down their companies.

Traditional ERM-based approaches tend to dwell on the most visible risks–those often not linked to business strategy–so they rarely identify and seize opportunities that can lead to greater profits and competitive advantage.[1] If the ERM program does focus on the strategy, the attention is usually on the top risks to the execution of the strategy with no real focus on the assumptions underlying that strategy. This approach is more focused on value protection, rather than value creation.

This was demonstrated clearly in a recent collaborative study conducted by Deloitte & Touche LLP and the Original Equipment Suppliers Association (OESA) that surveyed North American automotive supplier executives.[2] Too often, automotive companies relegate ERM or the equivalent risk function way too low within the organization, and are too slow to develop a robust risk infrastructure. Of the 54% of

Deloitte-OESA survey respondents who do have a formal risk management program in place, many are not going far enough.

Automotive Suppliers with Formal Risk Management Programs in Place



Many suppliers know that ERM is not effective in identifying and responding to strategic risks. Focusing too narrowly on entity risk is comparable with rearranging deck chairs on the Titanic. Yet, history is replete with examples of probable events that failed to occur and improbable events that did occur. Why? A focus solely on ERM practices, which assess risk based on the likelihood they will occur, requires us to believe that what's going to happen in the future will be a repeat of what's happened in the past. ERM is not going to sense totally new changes or risks. Strategic risk allows you to look forward to identify potential threats that may come about from new business conditions and radically transform the performance of the enterprise.

Strategic risk defined
Strategic risks are the ones that threaten to disrupt the assumptions at the core of a company's strategy. They attack the business model and assumptions underlying the strategy, making it no longer valid.

Companies should consider cultivating both an ERM discipline, and an SRM view, to stay on top of the risks that threaten to disrupt the assumptions at the core of a company's strategy.

Whether you are a supplier in the throes of managing an expensive recall, or a product development team attempting to handle the intersection of mobile mobility and evolving consumer needs, one immutable fact remains: the risk lens in the automotive industry is shifting.

Industry Thinking on Strategic Risk

While the basic DNA of an automobile has not changed in over 100 years, there is no question that the industry is changing and being challenged in a completely new way. Globalization, technology, and consumer expectations are changing the game in the automotive industry and strategic choices made by suppliers over the last two decades are impacting the industry today. Who would have imagined that after 25 years of improvements in quality, safety engineering, and technology, the automotive industry would be awash in product recalls for basic components? Recalls now confer major heartburn to automakers and their suppliers with very real implications on the business strategy.

Despite the undeniable changes facing the industry and the high risks associated with getting it wrong, strategic risk has not yet been made a senior executive or boardroom priority. This creates potentially large exposures for failure and unintended results, as indicated in the Deloitte-OSEA survey.[3]

85% report their organizations are "somewhat effective" or "not effective" in identifying strategic risks and their implications

54% have a formal risk management program in place

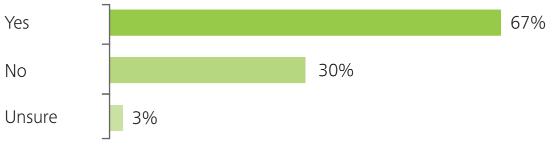
51% are performing or planning to implement integrating risk management into strategic planning, capital allocation, M&A, capital investment, and performance management

41% are fully addressing strategic risk by challenging their strategic assumptions and business models

Only 13% believe their organizations are "very effective" in identifying strategic risks and their implications

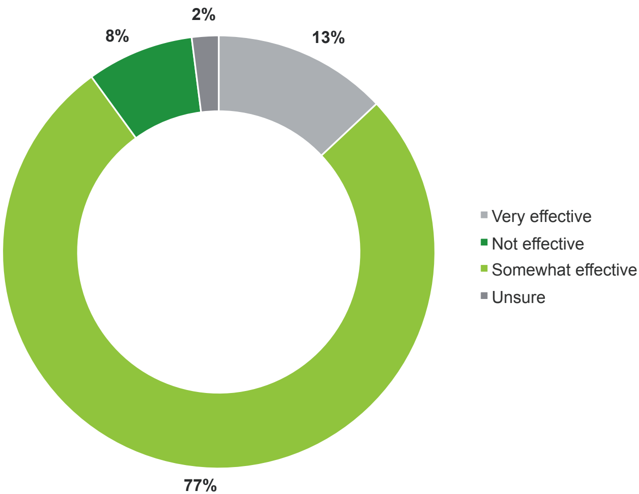
Given the potential for value-killing losses that can come from unexpected risks or "black-swan" events (those that have low probability, but very high impact), the fact that more than eight out of 10 suppliers rate themselves "somewhat effective," "not effective," or "unsure" about their ability to identify strategic risks and their implications should raise serious red flags in automotive boardrooms. Greater focus on strategic risk is needed.

Does your organization have an explicit focus on managing strategic risks?



Source: Deloitte and OESA Supplier Barometer Deep Dive, 2014

Overall, how effective do you think your organization is in identifying strategic risks and their implications?



Source: Deloitte and OESA Supplier Barometer Deep Dive, 2014

A leading automotive power generation supplier's inside-out strategic risk review uncovered opportunity. The company's long-term R&D efforts focused on **creating products** to meet future emissions standards and to **generate improvements** in fuel economy performance. In this case, growth has been fueled by a risk, converted to an opportunity that few saw as recently as five or 10 years ago: **the rise of stringent environmental regulations**. Many countries are tightening their fuel standards. China, for example, has set a standard of 47 miles per gallon by 2020. Suppliers that have SRM are usually prepared to address the threats and opportunities associated with these type of disruptions in the world's second largest economy.

Global Automotive Supplier Study, Deloitte Consulting LLP, 2014.

IT COULD NEVER HAPPEN HERE

"Many automotive brands have fallen by the wayside in the history of the US market. Some were no longer relevant, while others simply became redundant within the portfolios of their parent companies, an unsustainable situation in a competitive industry."

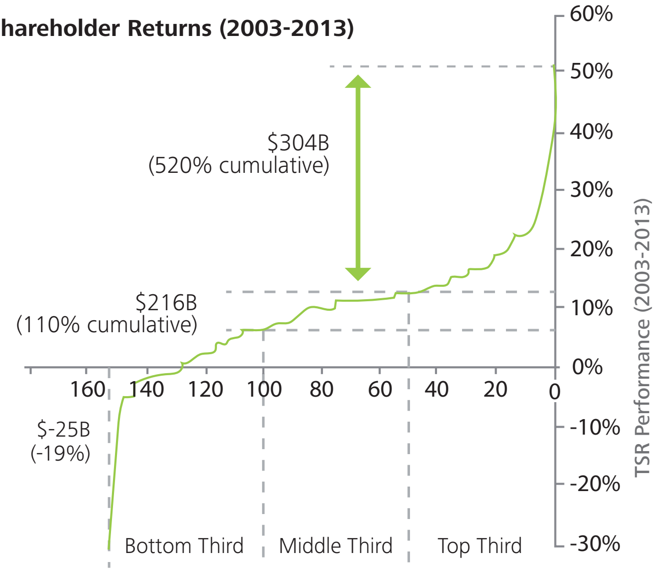
-ALG, Anatomy of a Brand's Demise

Good SRM, Happy Shareholders

SRM doesn't simply help organizations resist disaster and ruin. It is actually a fairly good indicator of positive shareholder returns. In fact, 10-year shareholder values were significantly higher at the 56 supplier companies who were "top performers" across six winning themes, all indicating a strategic risk focus, as reported in the Global Automotive Study.[4] The more than 210 suppliers in the study generated approximately $495 billion in shareholder value between 2003 and 2013. The top third of performers cumulatively generated 520% increase in shareholder value, and there was a significant value-creation gap between top performers and others. Middle-tier performers cumulatively generated 110% increase in shareholder value, while the bottom third reduced shareholder value by 19% over the same period. Top performers also had higher compound annual growth rates, returns on assets, revenue growth, and earnings before interest and taxes.[5] Although the earnings gap between top and bottom performers narrowed coming out of the economic downturn, it has more recently widened to exceed predownturn levels.[6]

This 10-year study identified those top performers who also had a clear a focus on strategic risks. Better performance and risk management, the data show, fit hand in glove.

Shareholder Returns (2003-2013)



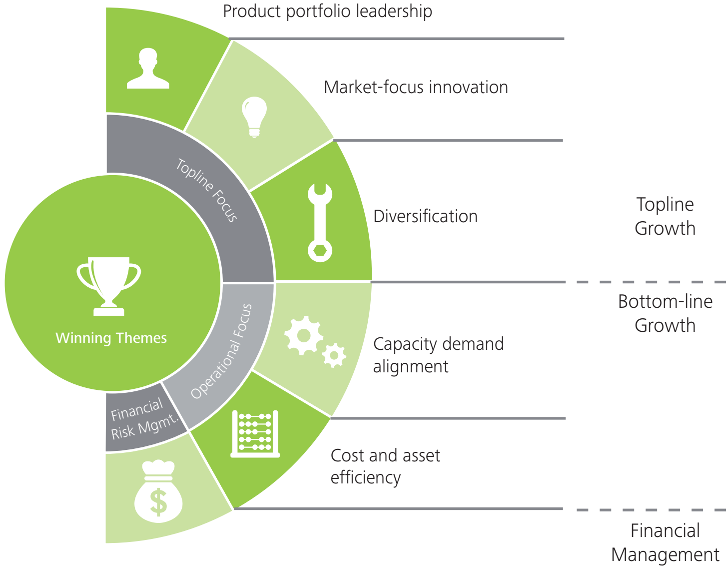
	Bottom Third	Middle Third	Top Third
2003 Enterprise Val	$132B	$195B	$59B
2013 Enterprise Val	$108B	$411B	$363B
Change	$-25B	$216B	$304B

Source: Global Automotive Supplier Study, Deloitte Consulting LLP, 2014

Under the Hood

The *Global Automotive Supplier Survey* revealed that SRM is closely correlated to six trends that drive superior shareholder value creation among top performers. These winning themes can be grouped into three areas: topline growth, operations, and financial management.[7]

Winning Themes



Source: Global Automotive Supplier Study, Deloitte Consulting LLP, 2014

Results from the Global Automotive Supplier Survey and Deloitte-OESA Supplier Barometer Deep Dive suggest that top-performing suppliers are using SRM techniques to improve decision-making and outcomes. What are they doing right?

1. **Topline focus** (portfolio management, market focused innovation, and diversifications)
   - Diversified product portfolio mix within auto industry and beyond
   - Mergers/partnerships to fill key product and technology gaps
   - Effective collaboration between suppliers and original equipment manufacturers to deploy new technologies and brand development
   - Proactive and disciplined innovation process that evaluates risk and return for new product

2. **Operational focus** (capacity demand management, and cost and asset efficiency)
   - Translation of strategic and long-range plans into day-to-day transactional risk management
   - Active multitier supplier risk management strategy
   - Outsourcing of noncore activities to maintain cost controls during unfavorable financial environment
   - Active currency and commodity risk management

3. **Financial management focus** (capital structure)

- Tailoring of capital structure (e.g., debt and liquidity) to economic conditions to take advantage of favorable financial environment or defend against financial shocks

Seventy-five percent of the impact to shareholder value came from the topline focus, which mainly deals with the continuous challenges to the business model's assumptions, a key staple of SRM. (Operational and financial management focus are the "table stakes" often covered by ERM.)

KEY RISK AREAS FOR AUTOMOTIVE SUPPLIERS

Why is managing and monitoring strategic risk so important for suppliers? Because minefields abound, including:

- Rapid pace of change and uncertainty
- Increased complexity of business operations and third-party alliances
- Technologies disrupting current business models and strategies
- Regulatory scrutiny
- Shareholder activism and board responsibility

Years ago, the US Army War College called it “VUCA”: volatile, uncertain, complex, and ambiguous. The years since then have only reinforced that the trends that created a “VUCA world” are here to stay, which means organizations will need “VUCA skills” to cope.

Forward-thinking organizations use a fully considered understanding of strategic risk to become a “force of disruption” rather than “one of the disrupted.”

Adapting to the New Environment

As globalization, digitalization, regulatory changes, expanding product modularity, and increased partnership activities bring greater risks and opportunities, suppliers must change their view of risk to adapt to a new environment. Doing nothing is perhaps the biggest strategic risk of all.

How to Build a Strategic Risk Capability

Few risks are as difficult to control and measure as brand reputation, competition, or innovation. Current risk governance may be too narrowly prescribed and inward looking to be insightful with respect to big strategic risks. In fact, many suppliers report that they are not optimizing their risk-management processes.

67% Conduct leadership meetings to capture new trends in identifying and monitoring strategic risks

46% Track external trends

39% Perform scenario planning

25% Conduct SRM-monitoring processes

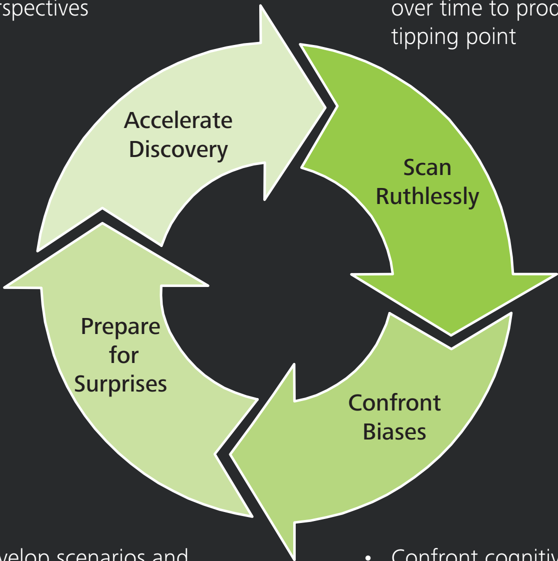
18% Deploy enhanced SRM-sensing processes

Source: Deloitte and OESA Supplier Barometer Deep Dive, Deloitte & Touche LLP (2014).

These capabilities are necessary to ensure agility, adaptability, and viability in the SRM program. But the organization needs to go beyond this cursory level to drive greater discipline and results.

- Create regular, systematic mechanisms to discover sources of surprises
- Identify trends that require specific attention
- Obtain fresh thinking from people who have vastly different experiences and perspectives

- Leveraging expert partners for trend analysis and scanning
- Develop internal teams/ processes to challenge the "dogma"
- Develop indicators of change that could add up over time to produce a tipping point



- Develop scenarios and learning journeys
- Identify triggers and outliers that help you think through a broad range of possibilities
- Learn to prepare for the future

- Confront cognitive or institutional biases
- Aggressively seek out information that contradicts what you believe to stress test your assumptions
- Involve third parties who will constructively critique and challenge your points of view and strategies

What Smart Companies Will Do

With a clear focus on business disruptors that pose both risk and opportunity, SRM should reverberate throughout the organization. Deloitte has developed a four-step SRM approach that helps to build and improve SRM capabilities for suppliers.

1

ACCELERATE DISCOVERY

Today's automotive suppliers must create regular, systematic mechanisms to accelerate the pace at which they discover sources of surprise.

2

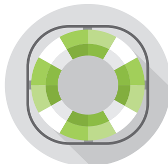
SCAN RUTHLESSLY

Any potential source of change won't come with a big sign that says "disruptor." Performing trend analysis and future scanning can surface small subtle indicators of change that could add up over time to produce a tipping point.

3 CONFRONT BIASES

"That will never happen" is the most dangerous phrase in today's c-suite. No matter how experienced, no human is immune to cognitive biases (or organizational ones), and once you admit you have them, you can step outside yourself to observe them.

4 PREPARE FOR SURPRISES



When an emergent risk turns into a strategic threat, it is too late to study the problem. You have to respond like a Navy Seal, with confidence, clarity, and precision.

Overcome inertia. Resist entropy. Drive technological change in your markets.

Great companies recognize that it is the events they rarely can predict that will reshape their businesses. Standing still is not an option—nor is resisting unexpected change.

Great companies understand the value of SRM and will apply fresh thinking and leverage expert partners at the appropriate organizational level.

Great companies focus their SRM framework on:

- A **bigger-picture view of risks** that combines ERM and SRM
- An ingrained habit of **questioning strategic assumptions** and challenging business dogma
- **Developing a risk-sensing mechanism** to identify potential threats and opportunities
- **Aligning risk management** with corporate strategy and scenario planning
- A demonstrated approach to **assessing, managing, and monitoring risk**
- A reasoned and **balanced risk culture**, in which risk is integrated into day-to-day operations, and all major decisions are evaluated through a strategic risk lens

Interested? Join the conversation.

In person

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[1] The Committee Of Sponsoring Organizations Of Treadway Commission (COSO) defines ERM as "a process designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives." http://www.coso.org/

[2] Deloitte and OESA Supplier Barometer Deep Dive, Deloitte & Touche LLP (2014).

[3] Deloitte and OESA Supplier Barometer Deep Dive, Deloitte & Touche LLP (2014).

[4] Global Automotive Supplier Study, Deloitte Consulting LLP, 2014

[5] Ibid.

[6] Ibid.

[7] Ibid.

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