

The Credit Crunch You Haven't Heard About...Yet.



For most businesses in the automotive sector, the signs of a sustainable recovery have seemed illusory. Despite official reports of improving fundamentals, from manufacturing to single family housing starts, senior managers and owners continue to hold their breath. Will there be a recovery this year? And if so, will it last?

The answer, in short, is yes. The automotive recovery has already begun, evidenced by increased production schedules in North America. But this upswing will be no panacea: the confluence of lower production volumes, tighter credit standards, and weaker lenders will make this recovery more difficult than any before. Banks have only now begun to discuss this looming reality. It is a crisis for which few are ready.

Autoconomy LLC and Simplicity Tactics have completed the following research and analysis to assist automotive leaders in positioning their companies for growth. Underlying economic data is current as of August 2009. Interviews with automotive managers and financial institutions were completed between August 3rd and 12th 2009.

Executive Summary

Key Economic Findings at a Glance

- **Leading economic indicators are signaling recovery**
- **The recovery in light vehicle sales is underway**
- **Sales adjusted for population, a measure of automotive saturation, will climb up from historic lows**
- **As a result of all these factors, 2010 anticipated light vehicle sales should push 13 million units**

Key Issues for Executives

- **Given apparent demand, historically low inventory levels throughout the supply chain are unsustainable**
- **Tighter lending standards and weaker financial institutions will create a liquidity bottleneck in the automotive sector**
- **Negotiations with creditors and lenders will generally provide capital insufficient to needs**
- **Generating cash flows necessary to support growth will require innovation in three main areas:**
 - **Inventory controls**
 - **Customer credit controls**
 - **Vendor relations**



The Autoconomy Letter

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The Autoconomy Letter provides Detroit auto news, auto industry analysis, car trends, and up-to-date economic information vital for decision making. It features market-moving auto industry news items and Autoconomy's opinion on the way in which these events continue to shape our industry. Events in the automotive industry and economy move fast and are constantly impacting your business. The Autoconomy Letter helps industry executives and managers stay on top of these events!

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About The Firm

Simplicity Tactics provides hands-on problem solving and support to manufacturing companies, governmental and non-governmental entities, and service firms. Offering expertise in areas as varied as commercial development, operational efficiency, and labor relations, the firm delivers discrete counsel to firms in transition.

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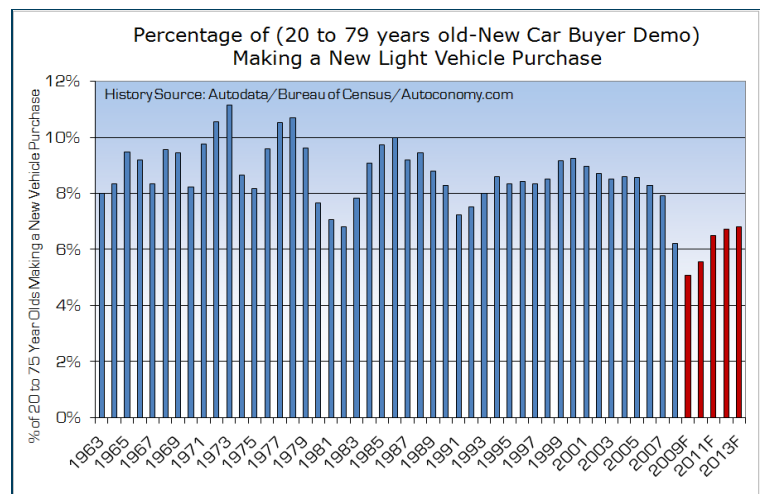
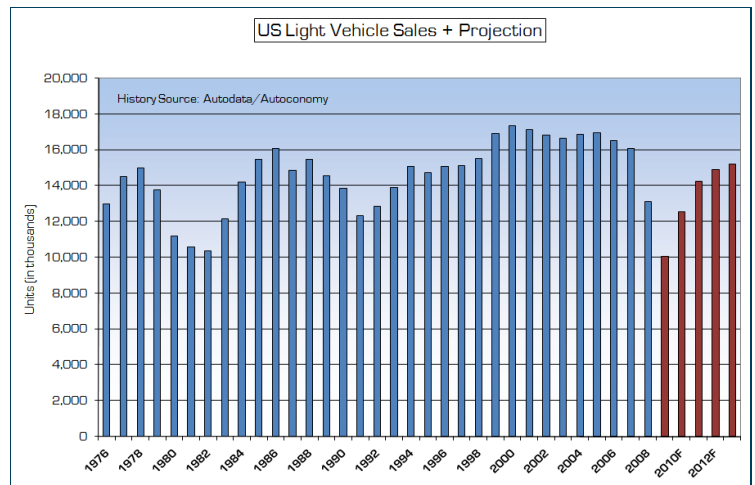
Autoconomy Analysis

by Erich Merkle, President of Autoconomy.com

The key question right now for companies in the automotive space should be how will you keep up with demand next year? It is a huge paradigm shift, particularly after all that we have been through over the last couple of years. In 2007, I was quoted regarding the very real prospect of recession. I used nothing more than historical economic data and the probability of this last economic cycle being markedly different from previous cycles. Housing was in recession for over a year prior to the broader macro recession and we had an inversion in the yield curve. When reviewing years of economic history the odds of these two indicators being somehow wrong or providing a false positive were almost impossible. We witnessed a very pronounced drop in housing, as many were debating recession/no recession. The prevailing wisdom is that things were somehow different then, just as they are today. I will bet with the house and leave hope to someone else's business planning.

Today housing has bottomed, its inventories are declining, we have a steep positive yield curve, the ECRI index of leading economic indicators is rebounding, and there has been a very strong lift in the equity markets, since their recent lows in March of this year. This represents the early signs of economic recovery.

Why are we so optimistic regarding the future of light vehicle demand? Again, using history as our guide, any time that we have a massive contraction in economic activity and auto sales, which we believe that the last 18 months would qualify as one of the greatest of the last century, we have seen a profound (not slow or subtle) return to light vehicle sales. The velocity coming out is almost as great as the velocity going into the downturn. While most people and businesses remain very shell-shocked, believing that we will never recover, many of the same people said that recession would never happen.



Sales adjusted for population chart

While we generally have a difficult time selling folks on a 25 to 30 percent increase (equating to 12.5 to 13.0M units) in light vehicle sales next year, there isn't a lot of risk in this prediction, particularly if you adjust sales for population growth. It has to happen. It's not quite as easy as "shooting fish in a barrel", but perhaps a shallow trough. The key question for auto industry management is whether or not you will be prepared for this upturn next year after industry capacity has been reduced and many of your competitors are gone.

Will you be able to capitalize on the opportunity or will someone else when sales move higher?

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Simplicity Tactics Analysis

Problem Description

While some might challenge the timing or rate of improvement in the longer term demand for manufacturing, this has little impact on the reality of the now. In the now, factory orders have begun to move upward quickly. Throughout the various supply chains, inventories are at or near lows not seen since the mid 1980's. The success of the first round of C.A.R.S. (aka Cash for Clunkers) has released pent up demand, further reducing vehicle inventories. General Motors and Chrysler each sit on less than 45 days of inventory.

While this appears to be a fully positive picture, few businesses have yet to realize that this confluence of sudden demand spike and low inventory levels will create a more pronounced and acute credit crisis than witnessed in the prior twelve months. It is our position that this crisis, more so than weaker sales, poses the single largest threat to small and mid-market manufacturing firms.

Supporting our outlook are a few basic elements:

- 100% of all purchasing managers polled reported experiencing 20% or greater increases in third quarter automotive releases
- The second round of C.A.R.S. provides funding sufficient to spur sales by 500,000 units in the next two months
- Tighter lending practices have been reported among national, regional, and local banking institutions
- Reduced borrower attractiveness due to weaker balance sheets
- Formula-based reductions in credit line availability from lower AR and inventory levels
- Lagging commodity production and attendant increases in commodity pricing

From these elements the most likely scenario quickly emerges. The sudden uptick in demand will cause a whiplash effect in the automotive supply chain. Companies will be forced to replenish their raw materials supply. Low inventory levels combined with lower commodity output will cause a rapid increase in raw materials costs. To protect their income statements, firms will seek to increase their inventory positions against announced price increases.

For those already severely capital constrained this will not be an option, and they will be unable to purchase materials sufficient to meet customer releases. Firms with strong balance sheets will build inventories beyond immediate needs, causing cash positions to rapidly deteriorate. In either case, few lenders will want to participate in additional credit lines, preferring instead to manage risk by consolidating working capital lines in those who survive. At this point the credit crunch will reach full effect, impacting both stronger and weaker firms alike.

Those able to successfully turn inventory into Accounts Receivables will find a brief respite, as lending formulas provide improved cash flows to meet the next month's purchases. But then customers will begin to stretch payments, and cash needs will once again climb. In this late stage of the crunch, companies able to quickly collect their A/R (or utilize the TARP program to sell this A/R) will emerge as true winners. Risk-averse lenders will then return to the market, offering attractive credit lines to these better performing manufacturing companies.

This turn of events is a nightmarish version of the historical upturn. And though companies caught unprepared will face almost insurmountable challenges, there is still time to prepare a firm to successfully navigate the looming crisis. Unlike other upturns, though, negotiations with lenders and suppliers over credit lines and terms will prove necessary but insufficient.

You aren't ready for this – but you can be.

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Required Response

As stated before, it is unlikely that vendors or commercial lenders will provide credit sufficient to meet market demand. Firms unable to utilize the TARP mechanisms for A/R sales will experience a pronounced credit crunch. Thankfully, these companies are still in a position to control their own destiny. To do so they must go against their natural profit based nature and focus primarily on their cash flow statements.

Generating the needed cash flows will require innovation in three main areas: inventory controls, customer credit controls, and vendor relations.

The most easily controlled yet most complex to implement, today improvement in inventory controls offer the single largest area of cash generation for most firms. Why is this? For a firm currently working under a four-turn plan, the successful transition to a five turn plan can eliminate almost the entire cash deficit created by a thirty percent increase in the order book. Making this leap, though, will require significant hands-on resources as well as a deep mechanical understanding of how to make rapid improvements.

Areas of focus should include:

- The adoption of an inventory neutral or stock-out bias, from a historical bias toward overstock
- Coordination of smaller production runs and reduced inventory levels
- Elimination of inventory "boneyards" and consistently slow-moving parts
- Micromanagement of ERP system restocking levels to reflect spasmodic but increasing sales

At the same time, companies must improve their accounts receivable pool by supporting customers with stronger balance sheets and cash flows. Unfortunately, this is no easy task. Customers might agree to a modification of credit terms without the ability or intent to meet these new terms. In this case, an ounce of prevention is worth far more than a pound of cure.

To adequately prepare, manufacturers should:

- Garner customer support by beginning the credit line discussion early
- Review the recent statements of all publicly traded customers
- Enlist sales support in asking the client's purchasing team for support in reviewing financial statements, with the promise of increased lines for creditworthy accounts
- Offer very large discounts – 2% 10, net 30 – to improve cash flows, and pay attention those who cannot accept the offer

In this credit constrained environment, the early bird will once again get the worm. In this case, manufacturers who move first to consolidate increased credit lines will outpace their competitors. While those who wait will be consigned to a single choice – begging – those who begin today will find themselves with myriad options, including:

- Increasing the number of suppliers to spread credit risk and improve overall availability
- Trading higher purchase prices for smaller and more frequent deliveries, reducing short term A/P levels
- Offering security to unsecured trade creditors

For those questioning either the economic analysis or tactical assessment, there is little risk in adopting the tactical response above. Even if both are incorrect, the resulting improvement in cash flow and balance sheet health create the basis for stable ongoing performance in both the short and medium terms. Business leaders should therefore examine the only potential trade off –reduced income resulting from higher purchase prices or increased discounting by customers – and discuss adoption of this risk averse position with their lenders and vendors.