Feature

Industry Challenges for Canadian Auto Parts SMEs:

Mapping a Constructive Path for the Future

By Joe Atikian, Economics Author & Valitas Capital Partners

At a glance, the post-recessionary Canadian auto parts industry looks healthy, but a more retrospective view reveals a troubling reality. We are eight years into the current business cycle, yet output is still 18 per cent below its pre-recession peak reached in 2005. Why is this?

There is a growing technology deficit in the Canadian auto parts industry, and there is pressure to follow OEM customers to Mexico, and this situation is being exacerbated by a long-run decline in the peso. With these factors in mind, our outlook for owners of auto parts SMEs is that the two aforementioned forces will continue to drive significant capital needs in the industry. Those who fail to invest will be left in the rear-view. Chinese manufacturers will act as an emerging force in the global automotive industry, with ambitions to deploy capital in North America.

Overlaying all of this, business owners across the Canadian manufacturing industry are aging and, in many cases, lack viable succession plans.

In light of these powerful forces, owners of Canadian auto parts SMEs would be well-advised to act quickly and position themselves for long-term competitiveness by investing heavily to modernize and better-align themselves with their customers, or partnering with—or selling to—strategic buyers or private equity investors who have the capital and know-how to execute these strategic moves.

The backdrop

Despite its tenuous post-recession rebound, the auto parts sector may currently be showing signs of longer-term fragility. Revenues and jobs are both down since their historic peaks in 2005 and 1999, in stark contrast with overall national business sector GDP, which currently sits at a record-high. The causes are well-known: the shift of automotive investment to Mexico (exacerbated by continued weakening of the peso), the 2008 recession, and lagging technology adoption. In addition, a renegotiation of the North American Free Trade Agreement may burden Canadian producers with increased country-of-origin restrictions.

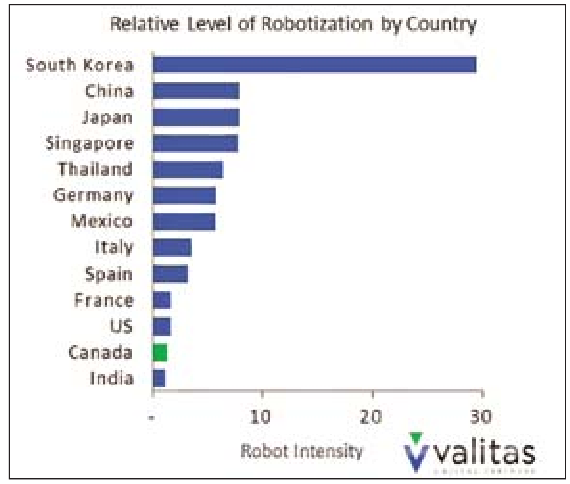
As can be seen in the first chart at the top of the next page, these factors are set against a Canadian backdrop where demographic changes, combined with lax succession planning, are putting business owners in peril for a significant destruction of family wealth. Approximately 80 per cent of Canadian businesses are owned by Baby Boomers nearing retirement age. Most private businesses, including those in the auto parts sector, fare poorly without their founders and lack an ownership transition path at the time the founder exits the business.

While this paints a gloomy picture, there are clear pathways that lead to positive outcomes, particularly given sustained strength in mergers and acquisitions activity driven by pent-up liquidity among corporate and financial buyers. This liquidity includes US$1 trillion in private equity dry powder paired with highly accommodative credit markets and an additional US$2 trillion in cash on corporate balance sheets.

Has automation impacted competitiveness?

From a jobs and output perspective, Canadian auto parts manufacturers are lagging compared to the rest of the economy. The rise of the Mexican auto parts industry and value of the Canadian dollar relative to the peso are partly to blame, but the Canadian auto sector's track record on automation also plays a role. The implications are dire for Canadian SMEs.

Does automation account for declining employment in Canada's parts manufacturing? Contrary to common perspectives, countries with more intensive robotization tend to have more robust manufacturing employment in their economies. Canada significantly



LEFT:
Chart 1. Traditional manufacturing lags behind the broader economy.

RIGHT:
Chart 2. Canada significantly trails world leaders in automation.

lags behind other advanced economies in its usage of industrial robots, ranking a distant 12th among leading nations in robot investment per unit of GDP last year.

Even more concerning is the magnitude of the robot intensity gap. The world's leader, South Korea, is estimated to use over 13 times the number of robots per unit of GDP that Canada employs. Mexico, Canada's most direct regional competitor, as well as Germany, Japan, and China, employ up to six times the number of robots per unit of GDP than Canada, and all four countries have a higher share of employment in the manufacturing sector than Canada.

These observations lead us to conclude that the decline in auto parts jobs since 1999 signals a fundamental shift in the auto parts sector. Lower relative levels of robotic automation reduce growth in efficiency, competitiveness, and ultimately, jobs, as OEM buyers increasingly see advantages in pricing and quality from offshore sources. Consequently, low investment in automation reduces the long-term prosperity of individual firms, some of which may not survive this ongoing shift in industry fundamentals. Taking this into account, what actionable options do auto parts SMEs have?

Mapping the path forward

In the current environment, small- or medium-sized firms are increasingly vulnerable to damaging economic forces. For these entities, two viable paths emerge. The first embraces an efficiency theme, with the obvious route being modernization of a firm's production processes to close the competitive gap with European and Asian producers. Increased scale may be another avenue toward efficiency, driven by options like growth-oriented acquisitions or a merger with similarly-sized, complementary firms. The second path is the development of a viable transition plan to the next generation of family or to an external buyer. Each path has its own unique considerations.

Modernization takes time and effort, not to mention significant financial resources. While financing can be accessed through traditional or creative equity and debt options, the magnitude of financing required may exceed the scope and appetite of many small- and medium-sized business owners. For those following this path, the objective would be to strengthen the business by increasing efficiency and profits, justifying the expense of the financial undertaking.

Another part of the modernization-for-efficiency theme includes shifting production to locations with lower input costs. Mexico is an obvious choice because of its currency and proximity to OEM customers. Locating production facilities in Mexico may also bring a new advantage from China's car makers. Chinese car makers will soon want access to the world's biggest, most profitable automobile market, the U.S. Chinese car makers will seek to become foreign domestic producers in the U.S., in addition to expanding their Mexican-based production for global export. Canadian auto parts producers with production capability in Mexico will likely enjoy a growth advantage in supplying future Chinese transplants within North America.

Chinese parts producers are also looking for opportunities in the NAFTA zone. They are already interested in firms that have American customers. For Canadian suppliers considering a sale of their business, this is an important factor to keep in mind. If a longer-term transition plan is an option, charting an interim path that creates additional value, such as recapitalizing to invest in Mexican production facilities and modernization, may generate the most attractive valuation in an eventual sale.

The choice each manufacturer makes will obviously be dictated by personal circumstances, but there are increasingly only a few clear options to address current industry challenges. Owners can either invest to remain competitive or execute a short-term transition plan to sell the business to a buyer that is ready to invest, modernize, and compete. A hybrid option, for owners with the luxury of not needing to address a transition in the near-term, is to invest and create value for an eventual sale of the business down the road. ■

...there are clear pathways that lead to positive outcomes, particularly given sustained strength in mergers and acquisitions activity driven by pent-up liquidity among corporate and financial buyers.

Joe Atikian (www.atikian.com) has 23 years of utilities and automotive engineering experience. He has authored several books on economic development. Valitas (www.valitascapital.com) is a boutique Canadian mergers and acquisitions advisory firm. The Valitas team has completed about 200 mergers and acquisitions and financing transactions.