

# How OEMs and top-tier suppliers can not only navigate the downturn but come out ahead

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Since the Great Recession, the face and focus of the automotive industry have changed significantly.

Technology-driven investments, new product entrants and growth in partnerships across industry sectors, fueled largely by a shift toward “ACES” – vehicles that are automated, connected, electric and shared – challenge and reshape traditional automotive industry models.

In response to tightening profit margins for new vehicle sales, original equipment manufacturers have consolidated and streamlined supply chains.

Automakers now have more robust relationships with fewer suppliers, which often involve holding suppliers to fixed prices for key components for several years (prior to applying phased price reductions) and relying on them for a greater number and range of components.

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Somewhat paradoxically, while supply lines have streamlined, there also has been an explosive increase in the number of participants in the automotive supply chain.

In particular, tech companies of all sizes are entering the auto space and building platforms for mobile entertainment and connectivity, as well as other significant components.

As the industry changes, however, headwinds remain. Entering 2020, OEMs saw increasing numbers of vehicles coming off lease or retired from car rental fleets<sup>1</sup> as well as increased ride-sharing or other alternative modes of transportation.

To make matters worse, higher raw material and labor costs, when paired with vehicle prices that have remained largely flat since the late 1990s,<sup>2</sup> resulted in decreasing profits per vehicle – decreases that were not offset by efficiency gains.

Then, COVID-19 hit.

Automakers are reporting plummeting Q1 sales,<sup>3</sup> while numerous factories have shuttered their doors (at least temporarily) or have been repurposed to produce ventilators and other medical devices.<sup>4</sup>

OEMs and top-tier suppliers are experiencing widespread supply chain disruptions, with 80% of the world’s automotive part components and subcomponents connected to China.<sup>5</sup>

As debilitating as these developments may appear, market downturns can lead to strategic opportunities.

If OEMs and top-tier suppliers take aggressive action in two key areas, they will be better positioned to overcome the current economic downturn than they were last time around.

Specifically, they must:

- (1) Proactively identify and manage supplier distress; and
- (2) Seize opportunities for long-term technological development, partnership and innovation.

To that end, this commentary will highlight key signs of supplier distress and steps that OEMs and top-tier suppliers can take to address them, as well as strategies these organizations may adopt to seize technology-related opportunities – including through distressed M&A.

## HOW TO IDENTIFY SIGNS OF SUPPLIER DISTRESS – AND WHAT TO DO ABOUT IT

During the incipient economic downturn, OEMs and top-tier suppliers must exercise vigilance with respect to supplier distress – or risk potential distress of their own.

In the wake of the Great Recession, nearly half of all U.S. auto suppliers faced bankruptcy.<sup>6</sup> Yet, even in prosperous economic times, failing to monitor supplier health can have disruptive consequences.

In 2016, for instance, General Motors had to temporarily halt production when its sole supplier of acoustic dampening materials filed for Chapter 11 protection.<sup>7</sup>

Even with developments in electric vehicle technology, the average car still consists of roughly 30,000 parts, many of which are sourced from smaller, more vulnerable suppliers.<sup>8</sup>

The more consolidated, streamlined nature of today's auto supply chains means that the failure of a key supplier can leave automakers with few alternative sources.

COVID-19 has begun to manifest significant supply chain risk and uncertainty, much of which will become fully apparent only when shutdowns and travel restrictions ease.

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At the same time, these organizations must proactively monitor their suppliers for signs of distress and actively address any concerns that arise.

This starts with open dialogue (likely confidentially) with the supplier to give supply chain managers the opportunity to assess whether the supplier's short-term difficulties are a COVID-19-related anomaly or whether recent events have simply accelerated existing distress.

Fortunately, recent consolidation in automotive supply chains has also provided OEMs and top-tier suppliers with heightened awareness and control over their supplier relationships.

This should empower those upstream in the supply chain to better identify signs of distress and to move proactively once those signs become apparent.

Signs of supplier distress include:

- Supplier requests for price increases, accelerated payment terms or customer financing support.
- Late deliveries, changes in product quality or product recalls.
- Material litigation claims.
- Management and board resignations.
- Failure to effectuate cost reductions.
- Spikes in commodity prices.

- Deteriorating accounts receivable and accounts payable.
- Employment of consultants and financial advisers.
- Announced divestitures and sale-leaseback transactions.
- Restatements or delays in issuing audited financial statements.
- Renegotiated debt covenants, incurrence of new debt, or fully drawn lines of credit.
- Growing leverage multiples.
- Steep declines in prices of public debt or equity and debt rating downgrades.
- Failed refinancing efforts or debt exchange offers.
- Impending loan or other debt maturity dates.

When entering into supply agreements, and again once the first signs of supplier distress become apparent, the OEM or top-tier supplier should review the supplier's contract for provisions controlling the parties' abilities to terminate the contract, the supplier's ability to stop shipment and the OEM's or top-tier supplier's ability to source production to another supplier.

OEMs and top-tier suppliers should also determine whether the contract can be deemed an executory contract (i.e., both parties have material, remaining obligations apart from payment) and assess the supplier's ability to assume and assign — or reject — the contract in bankruptcy, as well as other matters that may be impacted by a bankruptcy filing.

Smaller suppliers that provide critical parts should receive priority attention, as the ripple effect of financial distress is likely to impact them first due to smaller cash cushions and less accommodating lenders.

The shift to EV technology has also forced many such suppliers to revamp tooling and operations, requiring significant capital investments. This development, combined with the costs of restarting idled manufacturing lines, may push many suppliers into bankruptcy.

Depending on the distressed supplier's significance to the OEM or top-tier supplier's business, there may be a desire to actively participate in its pre-bankruptcy workout. Such workouts often involve accommodation agreements, under which the customers (e.g., OEMs and top-tier suppliers) provide the supplier with protections on inventory and receivables, commitments to continue sourcing existing parts to the supplier and limitations on setoffs, while lenders provide working capital financing commitments and foreclosure forbearance.

Customer accommodations may also include financing support, in which case the OEM or top-tier supplier should

obtain collateral for any financing it provides, as well as facility access agreements.

Customers providing financing support also may obtain intellectual property rights with respect to supplier product, or have such intellectual property assets put into escrow for the benefit of the customer.

If the supplier is unable to continue as a going concern and must file for bankruptcy, the OEM or top-tier supplier should consider bidding on it in bankruptcy as a “stalking horse” bidder.

Section 363 of the Bankruptcy Code permits the assets of bankrupt companies to be sold “free and clear” of all liens and other liabilities, which could allow the customer to obtain key assets from the bankrupt business.

Intimate knowledge about a supplier’s business may provide a significant competitive advantage to the customer in a bankruptcy auction.

### MERGERS, ACQUISITIONS AND OTHER STRATEGIC TECHNOLOGY TRANSACTIONS

Alongside management of existing suppliers, many OEMs and top-tier suppliers can mitigate the risk of future supply chain shocks through mergers and acquisitions or other strategic technology transactions.

OEMs and top-tier suppliers can expand their technological capabilities through a variety of legal arrangements, ranging from licenses, to investments and partnerships, to full acquisitions of technology-focused companies and talent.

**Technological innovation and collaboration among automakers and suppliers will become increasingly important, and those that take actions to increase their capabilities now will stand to benefit in the long term.**

Although licenses are typically viewed as the simplest way for automakers or suppliers to gain access to desired technology from a third party, without an exclusive license their competitors can license the same technology — thus making licensing a means to stay competitive rather than to lead the market.

To gain a competitive edge, automakers and top-tier suppliers can look to strategic investments — such as the purchase of an interest in a technology company, often accompanied by a long-term, strategic commercial agreement — or to a full acquisition whereby the automaker or supplier gains ownership of and access to all of the company’s technology and talent.

Such strategic investments may lie in leveraging distressed market conditions and supply chains to integrate new sources of technological innovation.

OEMs and top-tier suppliers using available resources to seize opportunities during the market downturn can continue to develop their technological capabilities, including investments in EV technology; collaborations to reduce dependence on lower-tier suppliers; and support for the development of shared and autonomous automotive technology — namely, by seeking out startups that have the critical talent and ideas but may lack the resources to survive an economic downturn.

By focusing on technological innovation and long-term, mutually beneficial relationships, OEMs and top-tier suppliers that take proactive steps now stand to benefit in the long term.

### EV MARKET OPPORTUNITIES

The EV segment of the automotive industry has been particularly hard-hit by COVID-19.

In addition to reduced consumer resources and new vehicle purchases, the EV supply chain is especially vulnerable<sup>9</sup> as a result of its dependence on Asia — particularly China<sup>10</sup> — for key ingredients, including lithium<sup>11</sup> and cobalt,<sup>12</sup> of its main battery technologies.

Bloomberg estimates that China will produce 70% of the world’s EV batteries by 2021.<sup>13</sup>

The economic downturn and supply chain disruptions resulting from the COVID-19 pandemic, combined with plunging oil prices,<sup>14</sup> have also created a poor outlook for short-term EV profitability. Current projections estimate that global EV sales will drop 43% this year, from 2.2 million in 2019 to 1.3 million in 2020.<sup>15</sup>

Nonetheless, widespread vehicle electrification is still on the horizon. Experts expect the EV market to quadruple in the next 25 years, accounting for roughly 11% of car sales.<sup>16</sup> With government policies in some jurisdictions already set to phase out internal combustion engine vehicles — and the fight against climate change expected to remain relevant beyond the impact of COVID-19 — automakers have made bold, public commitments to EV adoption. Volkswagen has committed to become carbon neutral by 2050,<sup>17</sup> GM “continues to drive toward an all-electric future”<sup>18</sup> with plans to sell a million EVs by 2026,<sup>19</sup> and Daimler has committed to electrify the entire Mercedes-Benz portfolio by 2022, to cite a few examples.<sup>20</sup>

OEMs and top-tier suppliers are making significant investments to expand EV capabilities. For instance, in June 2018, Magna announced it would form engineering and manufacturing joint ventures with China’s largest EV maker, Beijing Electric Vehicle Co. Ltd, to produce up to

180,000 electric vehicles annually.<sup>21</sup> In April 2019, Ford invested \$500 million in Rivian, an EV startup; the two are now working together to develop a next generation EV using Rivian's skateboard platform.<sup>22</sup> In December 2019, GM announced plans to invest \$2.3 billion in a joint venture with LG Chem, a major South Korean supplier of lithium-ion batteries, to build a factory for EV batteries in Ohio.<sup>23</sup> Given the current climate, EV suppliers in distress could soon become viable targets.

### DEVELOP NEW TECHNOLOGIES – INCLUDING IN COLLABORATION WITH OTHERS

The current supply chain disruption may leave automakers and top-tier suppliers feeling uneasy about overreliance on third parties to provide new technologies – particularly large technology companies that are looking to deliver the same services to a number of competing automakers and top-tier suppliers.

In fact, some OEMs and suppliers are working to increase their own technological innovation to avoid such overreliance. For example, in 2017, Toyota built its own data center, Toyota Connected, to build a “global cloud ecosystem” and “mobility services platform” to accommodate future services innovation.<sup>24</sup>

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OEMs and top-tier suppliers are also working with each other through a variety of legal arrangements, such as consortiums.

For example, in 2016, Audi, BMW and Daimler, acting as a consortium, acquired HERE Technologies – a mapping and location services business – from Nokia for \$3.1 billion to secure an “open, independent and value-creating platform for cloud-based maps and other mobility services.”<sup>25</sup>

Since 2015, Bosch and Daimler have partnered in developing fully automated driverless parking capabilities,<sup>26</sup> and most recently began testing an automated ride-hailing service in California.<sup>27</sup>

Technological innovation and collaboration among automakers and suppliers will become increasingly important, and those that take actions to increase their capabilities now will stand to benefit in the long term.

### SEEKING OUT STARTUPS AND TALENT FOR THE SHARED, AUTONOMOUS MOBILITY OF THE FUTURE

By one estimate, shared autonomous vehicles will make up over 70% of new car sales by 2040 – meaning OEMs and

top-tier suppliers should continue seeking opportunities to partner with, invest in and acquire smaller companies developing these technologies.<sup>28</sup>

While social distancing measures precipitated a sharp decline in ride-sharing, some transportation and mobility experts assert that this decrease is unlikely to be permanent.<sup>29</sup>

Further, some views are emerging that in response to social distancing measures, the use of AV could become a widespread trend – likely not in the short term, but sooner than anticipated pre-COVID-19.<sup>30</sup>

In this new territory, OEMs are already experimenting with – and often collaborating on – a variety of legal and business arrangements, demonstrating the power that lies in their existing industry knowledge and capital.

For example, in 2018, Ford acquired Autonomic,<sup>31</sup> a technology company building a platform – the Transportation Mobility Cloud – to accelerate and expand its mobility business operations.<sup>32</sup>

Last year Daimler and BMW announced a \$1.13 billion long-term strategic partnership involving more than 1,200 specialists working together on technologies for driver assistance systems and automated driving and parking.<sup>33</sup>

After Ford invested \$1 billion in Argo AI in 2017 – to develop a virtual driver system for Ford's AV (coming in 2021)<sup>34</sup> – Volkswagen announced it will invest \$2.6 billion in capital and assets into Argo AI as part of a broader AV and EV alliance between VW Group and Ford.<sup>35</sup>

OEMs should continue to explore opportunities for AV development, specifically in last-mile delivery, which remains the most expensive and time-consuming part of the delivery process.<sup>36</sup>

Prior to the pandemic, McKinsey predicted that AV last-mile delivery would be widespread within the next five to 10 years.<sup>37</sup> Social distancing and stay-at-home orders have only further increased consumer demand for delivery services, which likely will remain a key growth area for the foreseeable future.<sup>38</sup>

The present economic environment has been particularly rough on startups,<sup>39</sup> which often have the talent, innovation and ideas to develop critical automotive technologies but may struggle to survive – let alone scale up – in a distressed environment given their need for growth capital.<sup>40</sup>

Delivering critical technologies for future mobility, including shared mobility services and autonomous vehicles, requires immense industry know-how and capital.

OEMs and top-tier suppliers are more likely to have the industry knowledge, capital and ability to weather an economic downturn, and they should take advantage of opportunities to invest in and acquire tech startups during this time.

Here, too, technology companies (or their intellectual property) might be valuable targets as they fall into distress or bankruptcy. Larger industry players would do well to scour the market for new technologies that might be useful long-term investments.

**CONCLUSION**

As COVID-19 exacerbates existing market distress and disrupts emerging areas of growth, one thing is clear: Automotive OEMs and top-tier suppliers have an uncertain road ahead of them.

Yet supply chains look different today than they did during the Great Recession. They're more streamlined, but also chock full of new technologies — many of which have already been integrated into existing business models.

This new schema offers both opportunity and risk in these trying times: opportunity by way of strategic technology transactions, and risk by way of a more consolidated supply chain.

If OEMs and top-tier suppliers can take advantage of new opportunities — while proactively identifying and managing supplier distress — they will do more than just survive the immediate downturn. They will emerge poised for long-term success.

**Notes**

- <sup>1</sup> <https://bit.ly/3d3l29M>.
- <sup>2</sup> <https://mck.co/3f9uHic>.
- <sup>3</sup> <https://nyti.ms/2Wkib6P>.
- <sup>4</sup> <https://cnet.co/35tXY2E>.
- <sup>5</sup> <https://bit.ly/2KMU3V7>.
- <sup>6</sup> <https://reut.rs/2zJcFmp>.
- <sup>7</sup> <https://bit.ly/2yWJDj5>.
- <sup>8</sup> <https://on.wsj.com/2yY44Mo>.
- <sup>9</sup> <https://bit.ly/2StTGmC>.
- <sup>10</sup> <https://on.wsj.com/3f2HoLs>.
- <sup>11</sup> <https://bit.ly/2ykX9Np>.
- <sup>12</sup> <https://bloom.bg/2VTwikx>.

- <sup>13</sup> <https://s.nikkei.com/2VUcOrd>.
- <sup>14</sup> <https://on.ft.com/2KScIUy>.
- <sup>15</sup> <https://bit.ly/35kLA4K>.
- <sup>16</sup> [PitchBook\\_2Q\\_2019\\_Mobility\\_Industry\\_Spotlight\\_Electric\\_Vehicles](https://pitchbook.com/2019/Mobility/Industry/Spotlight/Electric/Vehicles).
- <sup>17</sup> <https://bloom.bg/3aRmuM1>.
- <sup>18</sup> <https://bit.ly/3fcbdJs>.
- <sup>19</sup> <https://nyti.ms/3f413Lb>.
- <sup>20</sup> <https://bit.ly/2Yo3rWZ>.
- <sup>21</sup> <https://bit.ly/2zGbtjJ>.
- <sup>22</sup> <https://ford.to/2zM8KoZ>.
- <sup>23</sup> <https://nyti.ms/2YqQVWO>.
- <sup>24</sup> <https://bit.ly/2y970WF>.
- <sup>25</sup> <https://bit.ly/2KPgbOv>.
- <sup>26</sup> <https://tcrn.ch/2WkjKJB>.
- <sup>27</sup> <https://cnb.cx/3fcrqH0>.
- <sup>28</sup> <https://bit.ly/3cZY1Wi>.
- <sup>29</sup> <https://tcrn.ch/2WbvpCM>.
- <sup>30</sup> <https://bit.ly/2SrmYSD>.
- <sup>31</sup> <https://ford.to/2SmDnry>.
- <sup>32</sup> Artificial Intelligence in the Automotive Industry — MA Trend Analysis, slide 11.
- <sup>33</sup> <https://bit.ly/2SrydKR>.
- <sup>34</sup> <https://tcrn.ch/2SnUFoo>.
- <sup>35</sup> <https://tcrn.ch/3gsmS7T>.
- <sup>36</sup> <https://bit.ly/3bXXSm4>.
- <sup>37</sup> <https://mck.co/2WgvZiv>.
- <sup>38</sup> <https://bit.ly/2zOEV7o>.
- <sup>39</sup> <https://on.wsj.com/2Yq8SEP>.
- <sup>40</sup> <https://nyti.ms/2WvekUH>.

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