AN AUTOMOTIVE DOWNTURN IS COMING—IT'S TIME TO PREPARE

By Brian Collie, Jonathan Van Wyck, Carsten Schaetzberger, and Katie Milliken

Auto OEMs and suppliers have recorded their longest stretch of continuous growth in history. That's worth celebrating. But a number of indicators suggest that momentum has slowed. Sales of new vehicles are down this year from last year's figures across the US and Europe, consumer sentiment has weakened, and loan delinquencies are on the rise. As Mike Jackson, the executive chairman of AutoNation noted, "It's getting harder to sell cars, and that signals the auto industry is about to enter a period of decline."

The precise timing of the next downturn is difficult to predict, but when it hits, the impact will be unlike anything the auto industry has experienced. In addition to managing falling volume, auto OEMs and suppliers will have to deal with massive shifts in mobility and digital transformation. Business models and markets are changing, and so is the competitive landscape, as tech and other nonautomotive entrants look to press their natural advantages and capture market share in this new environment.

Navigating the next downturn will require a very different playbook from the ones that worked in the past. Strong fundamentals such as managing cash and inventory will continue to be important, but the winning companies will also back bold plays and commit to growth. Leaders need to act now to develop a clear plan, build downturn-ready processes, and invest to win by doubling down on strategic bets that will secure their future.

Economic Momentum Is Weakening in the US and Europe

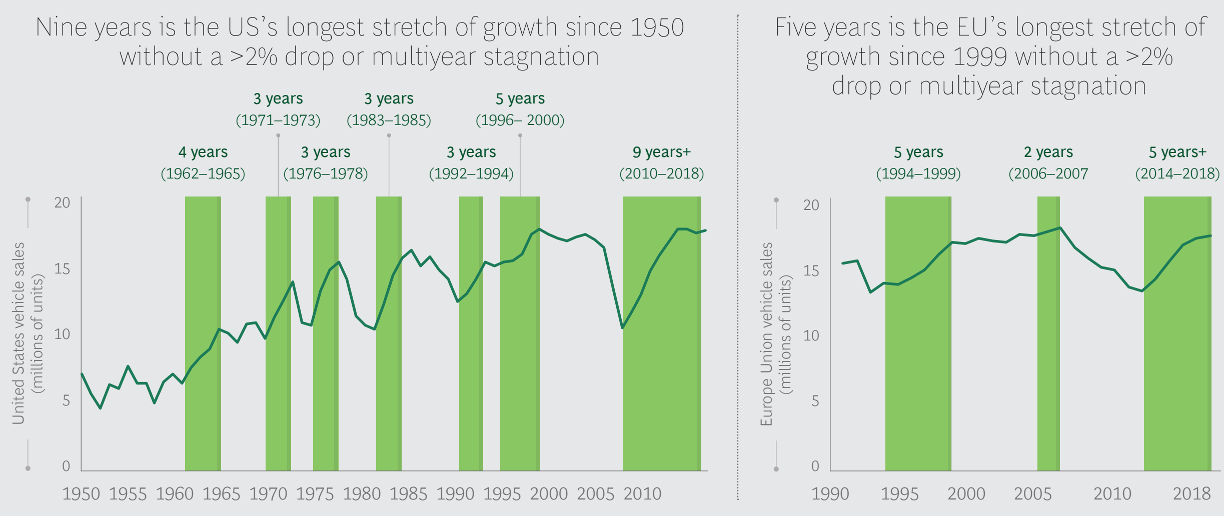
Although the US and Europe continue to enjoy economic growth, a number of signs suggest that the business cycle may be reaching its peak. Globally, GDP forecasts show signs of softening, with China expected to lose 60 basis points in growth between 2018 and 2020; the EU, 40 basis points; and the US, 100 basis points. The Asian auto market appears to have storm clouds of its own, but our clients are increasingly asking us about the outlook for the US and the EU, amid growing speculation that a downturn there may be imminent. Meanwhile, global trade uncertainty and increasing trade restrictions threaten to destabilize economies around the world. Total trade volume in North America is projected to decline, according to the World Trade Organization.

To address the question of what's in store for the US and European auto markets, BCG examined macroeconomic and automotive industry variables for each region.[1] Our modeling found that although auto markets on both sides of the Atlantic have enjoyed unprecedented growth in recent years, the ground is starting to shift. (See Exhibits 1 and 2.)

Between 2010 and 2018, vehicle sales in the United States grew from 11.7 million units to 17.7 million units, an increase of 50% (approximately 5% CAGR). Not since the 1950s have US automakers experienced a similar, nearly decade-long run of strong sales growth. But three drivers underlie a potential automotive downturn. One is a weakening economic outlook, as GDP is expected to decline between 2018 and 2020 and consumer sentiment is likely to remain mixed. A second driver is the possibility of an oversold market. The average age of a car in the US is projected to inch above ten years in 2019—older than at any other time in recent memory. Over the past ten years, auto financing levels have increased at nearly three times the rate of median household incomes (19% versus 7%), and auto interest rates are ticking upward, although they remain low by historical standards. The third driver is that higher incentives seem not to be generating higher sales, despite growing from 15% of MSRP to 22% from 2010 to 2019.

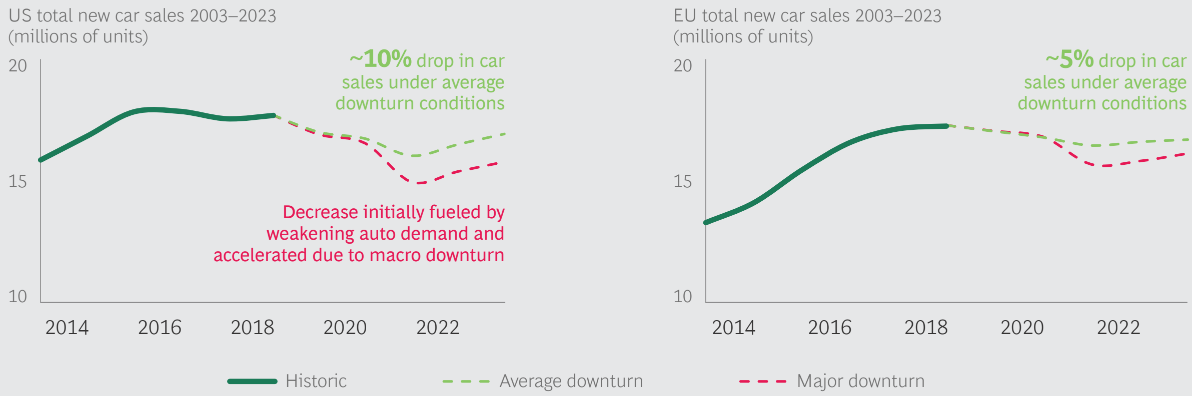
All told, auto sales for the period from January to April 2019 are down by roughly 2% to 3% compared with the same period in 2018. Our analysis suggests that this trend will continue, with sales likely to end the year 4% to 5% lower than in 2018. By 2020, the entire US economy is expected to slow. We project that the impending slowdown, combined with a number of auto-specific factors, will result in a cumulative drop in auto sales of 9% to 15% by 2021. That said, even though financial pressure is growing, OEMs still have some time to prepare, since the trough of the downturn won't arrive for at least another year. Moreover, the downturn is unlikely to be as severe or protracted as the 2008 recession. GDP, unemployment, and consumer prices should all bounce back without the reaching extremes of the Great Recession, and we anticipate that OEMs, suppliers, and the econ-

EXHIBIT 1 | The Auto Industry Has Enjoyed an Unprecedented Period of Growth



Sources: IHS Markit; US Bureau of Economic Analysis.

EXHIBIT 2 | Car Sales Are Likely to Fall by 9% to 15% in the US and by 5% to 10% in the EU by 2021



Sources: IMF; US Bureau of Economic Analysis; Federal Reserve; CBO; US Census Bureau; EIA; BCG analysis.

omy as a whole will return to growth by 2022 to 2023.

Meanwhile, car sales across the EU have also been robust. Over the past five years, new car volume has grown by roughly 4% year over year, from 14.1 million units sold in 2014 to 17.3 million in 2018. That five-year stretch marks the longest period of unbroken growth in Europe since 1999. Although market dynamics tend to be less cyclical in the EU than in the US, regional patterns suggest that the fundamentals have deteriorated. Our data revealed a major decrease in consumer optimism, with specific auto indicators weakening as well. Auto loan default rates are on the rise, and demand for driver's licenses among young people has fallen. In England, road tests are at record lows—having fallen almost 30% since 2008. Our modeling suggests that growth will flatten in the next 12 to 16 months, with an actual decline likely to occur around 2021—meaning that OEMs and suppliers still have time to act. We expect the downturn to eventually lead to a 5% drop in sales, although more-severe conditions could worsen that figure to 10%. As with our US forecast, however, we expect core model inputs in the EU to remain stable and sales levels to return to positive growth by 2022 or 2023.

Regional variations aside, all automobile segments will see a drop in sales during the downturn, but some segments will fare better than others. For instance, premium vehicles usually take less of a hit during a contraction—because their buyers tend to be less price sensitive—and that pattern is expected to remain true this time around, as well. The downturn is unlikely to halt the massive shift away from cars toward SUVs and trucks, a shift that is more pronounced in the US than in Europe. Volume in that segment will slow as market conditions weaken, but in-segment substitutions will offset the slide to some extent, as value-conscious consumers embrace crossovers. Although shared autonomous electric vehicles (SAEVs) are not likely to constitute a meaningful portion of new car sales for another decade or more, OEMs and tech players that cut back on their investments in this area during the downturn could harm their long-term growth.

The Next Downturn Will Come Amidst Massive Industry Disruption

Although forecast details vary, one thing is certain: this downturn will be very different from anything we've seen before. Over the next 15 years, three converging trends will permanently reshape the automotive landscape: vehicle electrification, autonomous driving, and shared mobility.

As the market moves from cars to SUVs and trucks—and from traditional internal combustion engine (ICE) vehicles to electric vehicles (EVs) to SAEVs—companies must transform their product offerings and their production capabilities to meet shifting consumer preferences. Ford and GM have publicly committed to significant investment in this segment in 2019. They and other major OEMs must stick to these commitments if they want to be ready to capitalize on the expected timeline for consumer adoption. Similarly, suppliers need to understand how to selectively invest to position themselves for growth as this trend develops, even in a softening environment.

Digital will become the de facto way of operating along the value chain. Advanced automation, AI, and additive manufacturing will reshape traditional processes. Control towers will provide real-time visibility of the supply chain, and personalization tools will change the way OEMs conduct marketing. Staying competitive will require investing in new technologies and adapting existing processes.

EVs may represent the future, but today consumers are still buying gas-powered vehicles. Consequently, OEMs must find a way to maintain legacy ICE powertrain assets while building capabilities around EV drivetrains in parallel. OEMs must adapt their production capabilities to meet shifting consumer preferences, even to the point of reconsidering historical make-versus-buy models, such as the decision to fully own all ICE capabilities.

Profit pools are changing, too. Our modeling suggests that sales of autonomous vehicles (AVs) and EVs, related components, data and connectivity services, and on-demand mobility offerings will account for 40% of total industry profits by 2035, up from just 1% in 2017. Cars that use alternative powertrains such as electric power, fuel cells, and plug-in hybrids are already seeing substantial growth. Suppliers should begin looking now for ways to create competitive advantage in the new mobility market. For instance, the prospect of radically redesigned SAEV interiors may give suppliers significant opportunities to create differentiated experiences.

As the pace of convergence accelerates, well-funded tech challengers are likely to make aggressive market moves, leveraging their heightened valuations by using equity as currency. The growing field includes big tech companies, specialty OEMs such as Tesla, mobility providers such as Uber, on-demand platforms, and niche startups. To defend their market share, incumbents will have to update their product offerings, refine their differentiation, and revisit their partnership arrangements—all while holding their ground against traditional peers.

Managing this balancing act during a period of slumping sales will take foresight, discipline, and commitment.

Business as Usual Will Not Work

Auto companies that attempt to ride out the downturn by hunkering down and applying the budget-slashing tactics they used in 2008 will emerge critically weakened—outflanked by competitors inside and outside the industry that continue to aggressively invest throughout the downturn.

This time around, businesses must do more than simply survive the downmarket. They also need to survive what happens after the downmarket ends. Our analysis of industry outperformers in past downturns found that growth heading into a downturn was more strongly correlated with financial health than traditional debt levers and expense reduction. OEMs and suppliers that focused on enhancing revenue growth, improving capital efficiency, and generating cash during the final year before either of the past two downturns struck emerged from the past two corrections with the strongest shareholder returns.

Going into this downturn with flexibility and momentum will be even more important. To release funding power and protect their critical strategic investments, OEMs and suppliers will need a different set of guiding principles than they relied on in the past. The good news is that there is still time to develop a plan. Some indicators are indeed softening, but the underlying economic picture remains strong. Rather than pulling back from the challenges ahead, businesses should use this period to take bold, proactive steps that will give them a decisive competitive advantage over the rest of the field.

How Automotive Companies Can Seize the Upside in a Downturn

The coming years will undoubtedly introduce new uncertainties and challenges, but OEMs and suppliers that create a downturn plan, build downturn-ready processes, and invest to win can use the downturn as an opportunity for renewal and advancement. (See Exhibit 3.)

Create a downturn plan. Companies need to go into the downturn with as much momentum as possible. Volume is already dropping, and leaders should agree on a plan of action immediately. To maximize flexibility and preserve funding power, automakers must align on their strategic and operational priorities, such as protecting market share or maintaining profitability. Those priorities will serve as a true north to help the business navigate the recession—providing important clarity and avoiding costly delays in decision making by managers and partners at every point on the value chain. Defining those priorities is not a casual exercise. Given the evolving mobility landscape, successful execution requires a deep understanding of current market dynamics, analysis of cash flows, and assessment of risk exposure and breakeven volumes along the entire value chain. One aspect of defining a company's true north involves being clear about how the company wants to balance investments in traditional business against new mobility. Once the company's leaders have identified priorities, they need to put mechanisms in place to ensure that critical long-term investments will not be jettisoned when things get tough.

Build downturn-ready processes. The companies that outperform their rivals during the next recession won't be the skinniest; they'll be the fittest, with lean operations, flexible systems, and agile work practices. Companies must look holistically across their business and evaluate everything from product creation to go-to-market strategies and be prepared to challenge sacred cows. To prepare their business for the coming downturn, leaders should focus on the following tasks:

- **Simplify the offering.** By raising hurdle rates on their investments, limiting cost proliferation, and seizing opportunities to cut products and programs that either are not aligned with the company's long-term ambitions or have delivered borderline performance, OEMs and suppliers can stretch capital and free up the resources

Exhibit 3 | Now Is the Time to Prepare Systematically for the Next Downturn

Source: BCG analysis.

needed to accelerate development of critical consumer-facing features.

- **Adopt a new approach to product cost.** The near-term priorities are to identify exposures and opportunities, create supply optionality, ensure supply flexibility, and scrutinize individual supplier risk. Beyond that, OEMs and suppliers should partner more closely, jointly identifying opportunities to drive efficiency, remove bureaucratic processes, and eliminate requirements that are out of line with industry standards. They should also avail themselves of digital tools and dashboards to improve data sharing and transparency.

- **Reinvigorate manufacturing productivity.** Business leaders should pressure-test their manufacturing footprint against different volume scenarios so they will be ready to align capacity with demand when the need arises. Operations leaders should take a similar approach in addressing their sales and operations planning processes and systems. Another priority is to stabilize underperforming plants, especially with regard to increasing labor and production flexibility and reducing inventory.

- **Maximize net price realization.** Rather than automatically resorting to discounts that might hamstring the business's cash position, leaders should build a granular understanding of pricing effectiveness, managing the tradeoffs between higher production costs and maximized economic profit from discounts and incentives.

- **Strengthen go-to-market planning.** OEMs and suppliers need to perform downturn-specific segmentation to anticipate which customers and dealers are likely to be most affected by a downturn. Using those insights, they can develop differential strategies to prioritize and direct marketing activities, digital engagement, and personalization initiatives.

- **Build a leaner, faster, more flexible organization.** Management should use the downturn as a time to strategically restructure the organization and attack bureaucracy by realigning resourcing levels, embedding agile ways of working, and accelerating results. Companies that eliminate waste effectively can channel their savings into other critical activities.

Invest to win. Cash-rich tech giants and nonautomotive entrants will be on the lookout for capital-constrained OEMs and suppliers. Many will be eager to capitalize on the industry's disruption to consolidate assets at bargain prices. Automotive leaders need to preempt such maneuvers by adopting long-term thinking, prioritizing bold strategic bets, and ring-fencing the investments necessary to secure their future. At a time when outside funding may be hard to come by, automotive players may find value in partnering to create scale in new mobility and other long-term investments.

Now is the time for leaders to review their M&A pipeline and identify promising strategic partners that can fill gaps in the company's portfolio—keeping future mobility and AV needs in mind. A downturn can present attractive opportunities to acquire critical talent and capabilities inside and outside the traditional auto sector. Well-placed investments can enable an automaker to leap ahead of slower-moving peers and gain a significant edge in innovation, development, and speed to market. Companies that use the period before a downturn to prepare themselves for it will be better positioned to seize attractive valuations when they arise.

Companies should also assess their portfolio and identify countercyclical growth opportunities. For example, in the aftermarket, OEMs and suppliers should undertake a granular, category-by-category assessment of their parts and services leakage. Those insights can help them adjust their offering, pricing, and inventory levels and see where to apply telematics data to target and engage customers more effectively.

It's increasingly clear that the automotive industry is in the early stages of a downturn. But while contractions are a time of uncertainty, they also introduce significant value-generating opportunities. Businesses that act quickly and decisively to embrace a new and more strategic playbook will not only rebound faster from the next downturn but also come out of it stronger than they were before.

Note

1. BCG analyzed a number of historical macroeconomic and automotive industry variables, as well as forward-looking assessments that included detailed sales projections, economic forecasts, and assessments of the potential impact of new mobility. Multivariate regression models incorporated adjustments for the length and depth of previous recessions and included assumptions about the timing and volume of adoption of shared autonomous electric vehicles.

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To learn more, please read "Emerge from the Automotive Downturn Stronger Than Before."