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Testimony of the Motor & Equipment Manufacturers Association Before the Senate Committee on Banking, Housing, and Urban Affairs Economic Policy Subcommittee: “Restoring Credit to Manufacturers”

Motor & Equipment Manufacturers Association (MEMA)

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Motor & Equipment Manufacturers Association
Before the
Senate Committee on Banking, Housing, and Urban Affairs
Economic Policy Subcommittee
“Restoring Credit to Manufacturers”
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The Motor & Equipment Manufacturers Association (MEMA) represents nearly 700 companies that manufacture motor vehicle parts for use in the light vehicle and heavy duty original equipment and aftermarket industries. MEMA represents its members through three affiliate associations: Automotive Aftermarket Suppliers Association (AASA), Heavy Duty Manufacturers Association (HDMA), and Original Equipment Suppliers Association (OESA). *(See Attachment 1)*

Motor vehicle parts suppliers are the nation’s largest manufacturing sector, directly employing over 685,000 U.S. workers and contributing to over 3.2 million jobs across the country. In fact, automotive suppliers are the largest manufacturing employer in eight states: Indiana, Kentucky, Michigan, Missouri, Ohio, Oklahoma, South Carolina and Tennessee. *(See Attachment 2)* Furthermore, suppliers are responsible for two-thirds of the value of today’s vehicles and nearly 30 percent of the total \$16.6 billion automotive research and development investment and are providing much of the intellectual capital required for the design, testing, and engineering of new parts and systems.

Without a healthy automotive supplier industry, the United States will lose a significant portion of this country's manufacturing innovation and employment base. The financial health of families and communities nationwide and the promise of a 21st century motor vehicle industry depend on a strong supplier sector.

Over the past ten months, significant and unprecedented government and industry actions have prevented a collapse of the largest manufacturing sector in the United States – the auto industry. It is estimated that the auto industry will expand production by two million units or 25 percent in 2010 over 2009. However, the future expansion, employment, economic contributions and structural viability of the supply base are dependent on continued access to credit. Only through continued coordinated action by industry, the financial community and the government will a future, potential crisis be prevented.

MEMA and OESA urge Congress and the Administration to:

- Assure sufficient capital for restructuring, consolidating and diversifying the industry;
- Address the specific needs of small suppliers for sufficient capital for ongoing operations; and
- Create technology funding programs that support suppliers' long-term product and manufacturing technology innovation.

History of Auto Supplier Support Program and GM and Chrysler Bankruptcies

To give some background, the Auto Supplier Support Program announced by the Auto Task Force on March 20, 2009, addressed only a finite set of issues. Small suppliers, suppliers manufacturing in the U.S. and shipping to Canada and Mexico and suppliers directly providing replacement and warranty parts and tooling were among the entities that found themselves without access to this program. The program, as administered, assisted a portion of the industry in surviving the downturn in production and vehicle sales. However, the program failed to improve required on-going access to traditional sources of capital for the vast majority of the industry.

With the bankruptcy filings of GM and Chrysler, 30 percent of the North American vehicle production base is in significant restructuring and transition. The Auto Supplier Support Program, which provided up to \$5 billion to guarantee the payment of supplier receivables, did help prevent widespread loan covenant violations and demands for changes in customer payment terms. However, OESA surveys indicated that while half of the direct suppliers to GM and/or Chrysler were eligible to participate, only half of those eligible suppliers were actually able to take part in the program.

There was a significant gap between those eligible and those able to participate because of issues in loading the thousands of purchase orders into the Citibank system and the general limitations on the types of eligible receivables and supplier bank restrictions. Even though in both the Chrysler and GM bankruptcies, most direct

suppliers were treated as critical vendors and received pre-petition payments on various terms, the process failed to address the serious needs of hundreds of suppliers to other vehicle manufacturers.

Without a doubt, the U.S. Treasury Auto Supplier Support Program helped avert a potential implosion of the supply base. However, significant risks remain to the industry and lenders alike. The major examples include:

- 1) **GM** – As the announcement last week of Penske Auto Group pulling out of a deal to purchase the Saturn distribution system shows, there is still significant uncertainty as to how brands, vehicle platforms and supply base consolidation will occur.
- 2) **Chrysler/Fiat** – We will not know until later this year final product cycle plans, manufacturing locations and other details that will provide lenders a view into which suppliers have forward business opportunities and which do not.
- 3) **The old GM and Chrysler companies in bankruptcies** – Until all the assets are completely disposed of, there will remain uncertainty over potential liabilities. Bankruptcy courts can still have oversight over on-going operations and the value of certain receivables to lend against.
- 4) **Bankruptcy of major suppliers** – While it appears these bankruptcies are moving smoothly through the courts, we cannot forget that few sub-tier suppliers are receiving critical vendor status and, as a consequence, most are not receiving full pre-petition payments.

The Current Situation

Suppliers have dramatically reduced every element of their working capital requirements from payroll to raw material inventories. Certainly, this is in part a response to the dramatically reduced production levels and an effort to conserve cash in a period of significantly reduced cash flows. However, many – if not most – of these changes will become permanent. These include:

- Workforce reductions;
- Plant closures;
- Compensation and benefit reductions; and, of course,
- Permanent closure of companies.

Our research indicates that there have been 47 identified major suppliers that have filed for Chapter 11 protection this year. (*See Attachment 3*) We have no definitive number of suppliers who have closed facilities, but Plante and Moran estimates that up to 200 suppliers have liquidated.

The result of this painful cost cutting and restructuring is a much lower breakeven point for the supply base. In the September survey of OESA members (*See Attachment 4*), the median breakeven unit level for 2010 is 9.5 million units. The respondents, in turn, estimate 2010 North American production volume will be 10.1 million units. This means that even with a modest increase in production, suppliers, on average, should be above their breakeven point next year. However, currently there is significant pressure

on the entire system to access adequate working capital to bring the manufacturing system back up.

There must be increased access to capital through the entire supply chain – from the largest tier one to the smallest family-owned firm in order to:

- Rehire workers and purchase raw materials for production increases;
- Retool for new programs; and
- Restructure internal operations and consolidate external capacities.

Lending conditions did improve in the second quarter of 2009 from the first quarter of the year. However, we need to keep in perspective how deeply frozen the credit markets had become (the supply side) and how significantly large the ongoing capital needs of the industry are (the demand side). GE Capital, in their Third Quarter 2009 Industry Research Monitor of the U.S. automotive base, reports that U.S. institutional term loan issuance was off 55 percent in the first half of 2009 versus 2008; in the second quarter, term loan issuance was still off 31 percent year over year.

The situation is improving, but is it improving fast enough? To give you a perspective of the capital requirements for this industry, it is not unusual to have a \$100 million supplier support \$5 to 10 million in customer tooling costs at any point of time. Access to capital is the cushion that keeps our supply base liquid. As one of our members said, “I pay my employees weekly, my leases every four weeks, my vendors every six weeks, and my customers pay me every eight weeks.” The need is evident.

There has not been a widespread failure of the system as suppliers have restructured or liquidated. However, issues regarding access to capital are showing up and an inordinate amount of attention is required to keep the supply base running. These are just a few examples from our membership:

- A very large international resin supplier needs to have daily phone calls with a domestic OEM to review production schedules as the resin supplier has supply issues with a sub-tier supplier in Chapter 11;
- A large international supplier could not get an additional loans to purchase specialized equipment to diversify into the aerospace industry as they are up against tight loan covenant terms;
- A smaller metal fabricating business could not get a loan to purchase equipment for a new line to deepen his capital base and keep his Midwest workforce competitive; and
- A small metal fabricator could not raise additional capital to invest in his Michigan operations and lost the business to Mexico.

These are not examples of capacity that needs to be rationalized. These are examples of suppliers that are looking to invest in the U.S., compete against global competition and support a profitable, productive domestic auto industry.

According to the OESA Automotive Supplier Barometer September survey, the majority of all respondents have not seen any significant change in lending practices as

judged by metrics from the cost of credit lines to commercial loan interest rates, covenants or collateral requirements. In fact, 23 to 46 percent of the respondents actually saw tightening across these various terms over the past three months. When OESA examined the responses by size of company (above or below \$500 million in revenue), it is clear that smaller suppliers face the possibility of even tighter terms.

A very positive thread through the comments relates to the level of cost reduction and restructuring that has taken place. Here, suppliers are optimistic that even if production schedules do fall off in latter part of the fourth quarter and into 2010, the trend toward regaining profitability will continue. This is an industry worth investing in. However, industry production volumes (driven by weak consumer spending) and absolutely low levels of asset valuations restrict credit availability even to suppliers that will be needed on the other side of this crisis.

Banks are forming their lists of which suppliers they will work with and those they will not. The OESA Automotive Supplier Barometer survey from July noted that 23 percent of suppliers characterized their banker as actively engaged with them while 19 percent described their banker as actively exiting the industry. We are worried about the 60 percent of the supply base in between that could be indiscriminately cut off from necessary access to capital. In fact, in a recent review of supplier financial distress monitoring systems, a group of chief purchasing officers concluded that predicting the failure of a supplier has more to do with their banking relationships than it does with their operational efficiency or revenue outlook.

Outside analysts confirm the views of our membership. According to the Summer 2009 Grant Thornton report, *The North American Automotive Industry in 2012: Supplier Opportunities*: “. . . as many as 30 percent of North American suppliers are at high risk of failure.” Grant Thornton expects restructuring will reduce supplier capacity by 30 to 45 percent. Using 1,700 suppliers for their base numbers, they forecast:

- 170 to 340 companies risk Chapter 11 restructuring;
- 340 companies risk liquidation;
- 170 to 340 companies need acquisition financing for consolidation;
- 50 companies require targeted financing for restructuring; and
- 630 to 970 companies may not need special financing assistance.

Given the parts sector is operating just above 50 percent capacity utilization, we believe that there will be a continued stream of bankruptcies and closures through the rest of this year. In 2010, we expect ongoing closures as the industry continues to operate at low –albeit increasing – production volumes. Although much of this is to be expected in an industry in transition, adequate capital is necessary to consolidate the industry in a rational, effective manner. Otherwise, production disruptions and failure of companies with critical capabilities may ensue.

There are three areas MEMA and OESA believe Congress and the Administration should focus on to lower the risk of potential production disruptions

and unintended employment loss as well as to establish longer term programs to enhance product and manufacturing technology advancement.

Focus on General Lending

Given low production volumes and temporary low valuations of industry assets, many loans to long-term viable suppliers are, in the short-term, “out of formula” for banks to consider. One idea the industry believes – along with several bankers we have spoken to – has merit is the Michigan Supplier Diversification Fund. The \$12 million program, currently in a “pilot” stage, is being funded by the State of Michigan and addresses three critical impediments to lending:

- *Cash flow* – by purchasing a portion of a commercial credit facility and offering preferred terms for up to 36 months to borrowers.
- *Collateral value* – by supplementing the collateral value on loan requests and depositing cash pledged to the bank.
- *Transitional risk* – by creating a mezzanine (bank of banks) model that can spread risk among several lenders and make both debt and equity investments.

It is important to investigate scaling this type of program up to a national level in all states to support a broad range of manufacturing entities.

Focus on Smaller Suppliers

Given the industry's significant capital requirements and the general mismatch of funding, a steady access to lines of credit and asset-backed loans is essential for the survival of the supply base. For example, it is not unreasonable for a small supplier to be called on for the investment of \$2 to \$4 million to assist with the design, engineering and tooling for a component on a new vehicle program. However, typically suppliers receive payment for this investment after the launch of production through the piece price of the component. The supplier might not begin receiving any cash flow on their investment for 12 to 24 months and will not be completely reimbursed until the product ends production in another 36 to 60 months.

Small Business Administration (SBA) programs have been at the foundation of small supplier support for decades. However, the SBA loan programs are limited to only \$2 million loans. Since suppliers are expected to fund a great deal of the research and development in the projects, the net worth and loan amounts have limited utility to our industry. Given the scale the auto industry operates on, this limit is too low to help many suppliers. A recent OESA survey indicated that a \$3.5 - \$10 million level would be far more helpful to small and medium automotive suppliers. Although small manufacturers should be able to turn to the SBA for loan programs, the current system is simply not designed to meet the needs of manufacturers with substantial raw material, research and development costs. Because of these limitations, recent changes to the SBA program have not dramatically impacted the ability of small suppliers to access capital.

Focus on Technology Funding

The supplier industry has worked with its customers and developed a wide range of new technologies that promote increased safety and improved fuel efficiency. This work includes:

- Batteries and engines for hybrid vehicles;
- Clean diesel engines;
- Direct fuel injection systems;
- Fuel cell technology;
- Lightweight materials;
- Innovative glass; and
- Advanced safety technology.

Suppliers are constantly called upon to innovate. The industry works daily with vehicle manufacturers to make vehicles safer, stronger, lighter, more fuel efficient, more economical and more environmentally friendly. This innovation takes investment in people, engineering, capital equipment, and research and development. Programs aimed at the supplier industry are needed.

MEMA and OESA support S. 1617, the IMPACT Act, currently under consideration, and H.R. 3246, the Advanced Vehicle Technology Act, which has passed the House. These bills will provide greater access to funding for the supply base. The technology

needs of the auto industry will require suppliers to invest in additional research and development, retool existing facilities and compete with sophisticated technology from overseas. (*See Attachment 5*)

Conclusion

We understand and support the need to consolidate the industry. However, we believe that without sufficient capital to provide a stable environment in which to restructure, the industry and its employees will witness unnecessary disruptions. Without assistance this country will needlessly lose manufacturing capacity, technology development and jobs.

This industry does not come before you requesting a bail out. However, we urge Congress and the Administration to invest with us in our future to achieve a stable economic environment, a strong employment base and a vibrant opportunity for technology research and development. We welcome an opportunity to work with the Committee.