



# Market leaders, market makers

By Umar Riaz and Eric J. Johnson

Auto suppliers as a group have outperformed both their customers and the S&P 500 in the seven years since 1997—by a significant margin. What's more, five high performers among them have excelled at sustaining superior levels of shareholder value creation.

■ Next time you settle into the comfort of your temperature-controlled car seat, reach for the games console in your ergonomic door panel, or operate your super-fuel-efficient, dual-clutch transmission, spare a thought for the folks who make these marvels.

Auto suppliers, the companies that manufacture just about every part of your car these days save the engine, have watched their profitability plummet during the past decade. They've been squeezed between the mounting demands of their automaker customers and the rising costs of raw materials.

But the plight of suppliers is not all grim. Since 1990, sales of auto parts have risen more rapidly than vehicle sales, largely because the automakers have outsourced more and more vehicle value to their suppliers. As a result, the auto suppliers as a group have actually done rather well, despite the profit pressures. Indeed, in the seven years since 1997, the largest suppliers have outperformed both their customers and the S&P 500 by a significant margin. What's more, five high performers among them have excelled in sustaining superior levels of shareholder value creation and could be considered cross-industry high-performance businesses (see "About the research," opposite).

When we looked at the drivers of these high performers' success, we were surprised. Operational excellence, a necessary but not sufficient driver of high performance on its own for their automaker customers, was a core capability for the auto suppliers. This strongly suggests that the key to excellence lies in the industry's own hands.

To be sure, consolidation, market (and customer) diversification, product innovation and improved operational efficiency are already well-established trends among auto suppliers. The number of Tier 1 suppliers—those that sell directly to the automakers—has shrunk dramatically since 1990, from some 2,000 to fewer than 800 today, and that number is expected to decline to about 100 by 2010. Sales growth in new, non-US markets now outpaces growth in the United States. Meanwhile, suppliers have diversified their customer bases as well, and today, sales to Top 3 customers account for just 55 percent of total auto supplier sales, compared with 65 percent in 1998. The suppliers have almost doubled their R&D expenditures too. And they are steadily improving productivity.

High performance, however, requires more than this. High-performing auto suppliers clearly generate superior growth (14 percent, compared with just 4.2 percent for their competitors), profitability (6.1 percent, compared with 4.3 percent) and operating margins (6.5 percent, compared with 3.9 percent). Moreover, they build that profitable growth by transforming a position of market leader, in terms of share, into one of market maker—actually redefining the boundaries of their market by innovating and by capturing more value in every vehicle. At the same time, they maintain exceptionally high levels of operational excellence. Here's how.

#### *Market leadership*

Although absolute scale does not, in itself, drive high performance, all five of the high-performing

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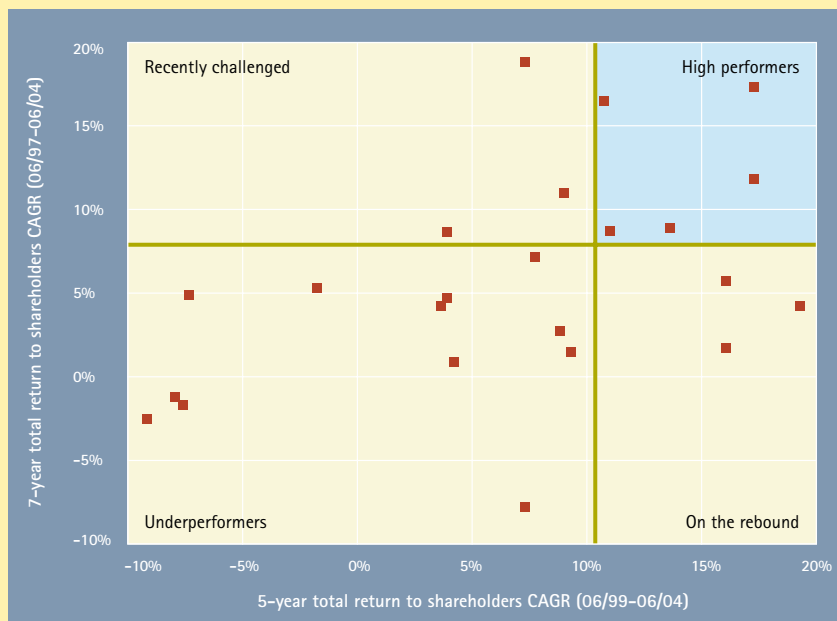
## About the research

To determine the appropriate peer set, we started with the *Automotive News* Top 50, a global ranking of auto suppliers based on their estimated OEM revenues. We then screened this list to select those suppliers that were:

- Tier 1 (those that sell directly to the automakers)
- Public companies (for at least five years) with actively traded shares
- Not majority-owned by an automaker (and thus not "captive")
- Primarily in the business of automotive supply, and not divisions of much larger companies

A peer group of 31 companies met our criteria. We then assessed the performance, and the longevity of outperformance, of these companies by calculating the total return to shareholders of each over three-, five- and seven-year periods. From this, we narrowed our list down to five companies whose performance placed them in the top quartile of the peer set for both the five- and seven-year periods and exceeded the median performance in the three-year period.

5-year total return to shareholders (CAGR) vs. 7-year total return to shareholders (CAGR)

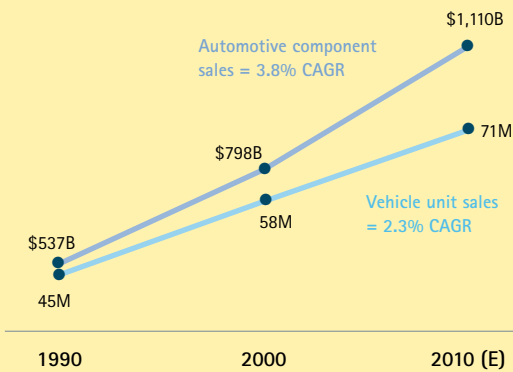


Interestingly, during the past two years, these high performers also outperformed both the four companies we identified as high-performing automakers and the S&P 500. The reasons for this appear to be twofold. First, high-performing suppliers may have benefited when the automakers slapped on customer incentives—cash rebates, for example, and zero-percent financing—that propped up sales volumes at the expense of OEM profitability. Second, car sales have remained at historic highs, so auto suppliers have had a lot of business.

## A bumpy ride

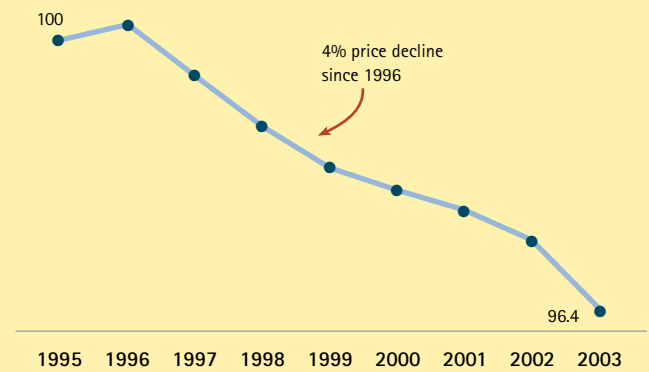
While supplier market growth has outpaced OEM sales growth . . .

Growth rates of component sales vs. vehicle sales



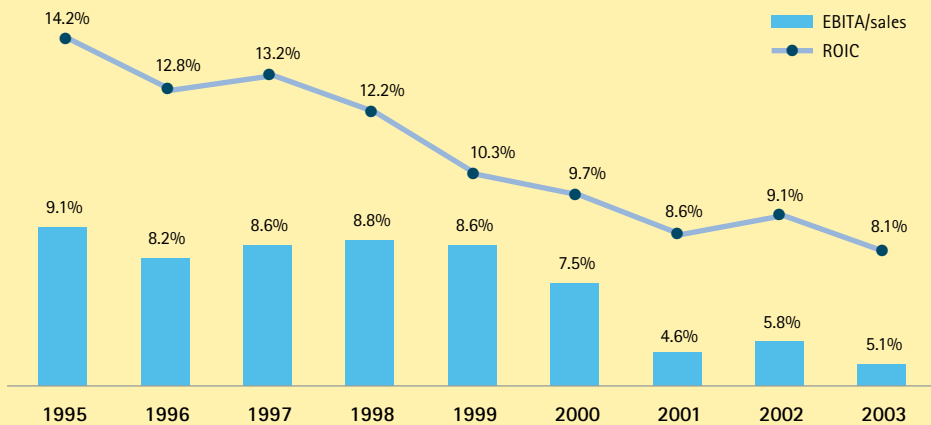
. . . continued downward price pressures on suppliers . . .

Automotive component price changes (US) (1995=100)



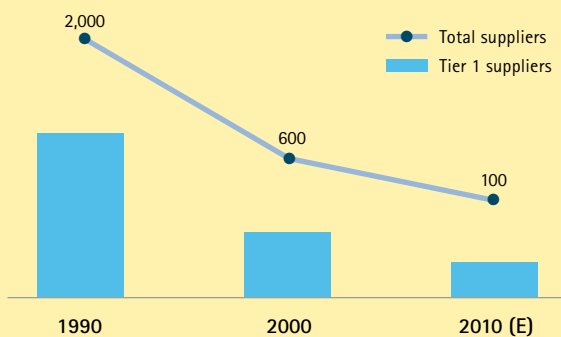
. . . have eroded profitability.

Supplier profitability



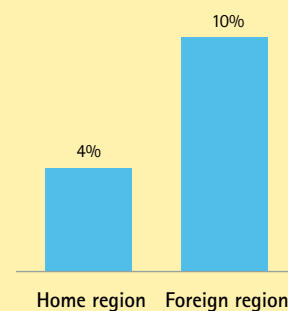
In response, suppliers have consolidated . . .

Number of global automotive suppliers

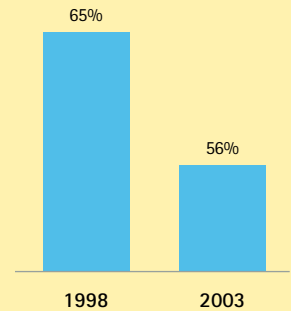


. . . become more diversified . . .

Sales growth by region (1998-2003)

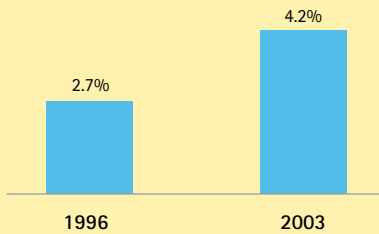


Top 3 customers as percent of total sales (1998 vs. 2003)



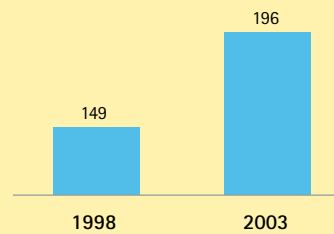
... with a greater focus on innovation ...

R&D expense as percentage of sales (1996 vs. 2003)

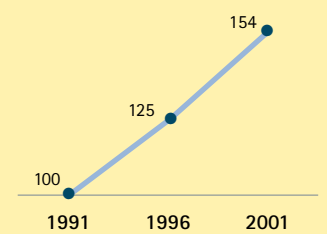


... and more efficient.

Revenue per employee (\$000) (1998 vs. 2003)



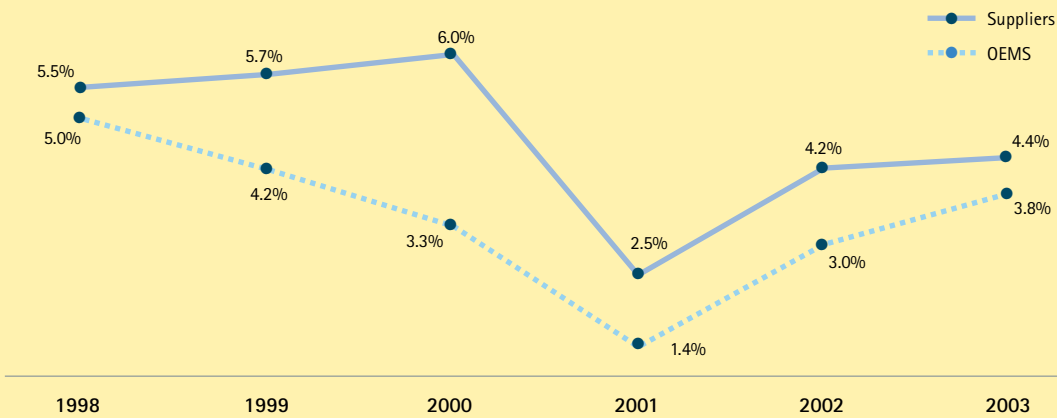
Index of labor output per hour



SOURCE: OESA; US BUREAU OF LABOR STATISTICS; BLOOMBERG; COMPUSTAT; COMPANY REPORTS; ACCENTURE ANALYSIS

As a result, they have outperformed their OEM customers ...

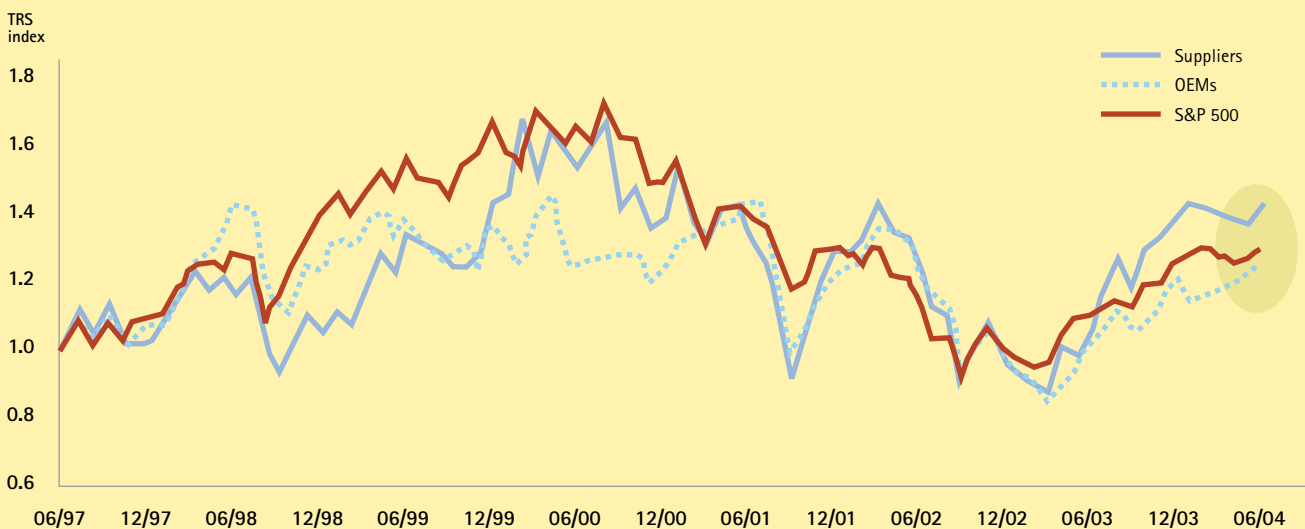
Operating margins (1998-2003)



SOURCE: ANNUAL REPORTS; STANDARD & POOR'S; ACCENTURE ANALYSIS

... and the S&P 500 in recent years.

TRS performance (1997-2004)



(Market-cap-weighted TRS index based on sample of 31 largest independent OEM suppliers)

## Johnson Controls: In the driver's seat

Johnson Controls (JCI) has been successful at transforming market leadership into market making—two of the key drivers of high performance in the auto supply industry (see story). The Milwaukee-based company was swifter than most of its competitors to recognize that fully integrated car interiors would be one of the fastest-growing industry segments—and it has penetrated that market more deeply as well.

JCI supplies complete interior modules, including a significant portion of the market for door panels and overhead systems. It cleverly influences the development of its product markets by integrating state-of-the-art electronics into interior components to create highly differentiated products.

JCI, having successfully sold its overhead rail storage system to some automakers—the product has been included in the 2004 Ford F-series pickup and in 2005 Chrysler group minivans—is now developing a prototype floor system designed to ease the movement of consoles from the front to the middle-row seats in minivans. Drivers will now be able to slide drinks

to the kids in back, for instance, without worrying about spills, since the console's electrical contacts will be safely tucked under the rail.

Successful differentiation in markets and customers is another JCI hallmark. The company jumped into the Asian market with the strategic acquisition of a major local seating supplier in 2000; it is also strong in Europe. Just 51 percent of JCI's automotive sales are in its home market (North America), compared with 63 percent for its peers. Only about a third (37 percent) of the company's sales are to its Top 3 customers, compared with the industry average of 55 percent.

Furthermore, since approximately a quarter (23 percent) of JCI's revenues come from non-automotive products (building controls) and an additional 8 percent comes from automotive batteries (which have a strong aftermarket), the company is somewhat insulated from the industry's cycles. JCI has enjoyed 58 consecutive years of increased sales, 14 consecutive years of increased income and 29 years of increased dividends.

*(Continued from page 20)*

auto suppliers we identified have achieved leading positions—on average, a 20 percent market share, compared with an average 9 percent share for other peer group members—in their core product segments (see case studies, above and on page 25). Moreover, although between 1998 and 2003 they were slightly more active in mergers and acquisitions than their competitors, by far the highest proportion of their revenue gains during that period came from organic growth.

### *Market making*

The industry as a whole, of course, is diversifying both its markets and its customers. But high performers appear to have the edge when it comes to what they sell in these markets. Having aggressively captured larger and larger shares of vehicle content—from tires and batteries to seating and instrument panels—they tend to specialize in

whole systems. We hypothesize that although this means lower gross margins, it also leads to higher levels of growth, employee productivity and lower SG&A costs as a percent of revenues.

Meanwhile, by investing in new production capabilities and by innovating at more than twice the rate of their peers, high performers continuously expand their markets.

### *Operational excellence*

High performers' R&D efficiency partly explains their significantly lower SG&A costs. These companies also appear to manage post-merger integration better than their peers, taking advantage of increased scale to further leverage their back offices. Their return on assets recovers more quickly to pre-merger levels as well. They make their assets work harder, achieving faster inventory turnover. And if sales growth warrants it, they seem more prepared than their competitors to move more of those

## BorgWarner: Green credentials

As the trend toward outsourcing transmissions manufacturing developed, BorgWarner was better positioned than its competitors to take advantage. As a result, the company quickly built a leading position across several high-growth segments in its core product markets, including four-wheel-drive transmission systems, turbochargers and dual-clutch transmission systems—with proprietary technologies.

In addition to transmissions, the Chicago-based supplier makes all manner of components and systems that help improve vehicle performance and stability, fuel efficiency and air quality, from cooling systems to turbochargers.

In Europe, where the demand for “greener,” more fuel-efficient transport has been strong, BorgWarner has done especially well. With its DualTronic technology, the company basically created the market for dual-clutch transmission systems, which improve fuel economy and emissions by as much as 15 percent. With dual-clutch transmissions expected to

capture 20 percent of the European passenger car market by 2015, BorgWarner’s early lead should translate to significant revenue growth. With sales of global diesel-powered light vehicles also predicted to more than double by 2015, sales of the company’s turbochargers for diesel engines should grow strongly as well.

Like Johnson Controls, BorgWarner has diversified, both geographically and in terms of its customers. Only about half its 2003 revenues came from Top 3 customers—beating the industry average. And its \$1.4 billion backlog of new business from 2005 to 2007 is one of the strongest in the industry and should continue to propel BorgWarner’s strong revenue growth.

This strength shelters the company from the automakers’ punishing cycle too. In 2003, BorgWarner posted double-digit revenue and earnings growth, despite essentially flat light-vehicle production in North America and a 2 percent decline in Europe.

assets overseas in pursuit of lower manufacturing costs.

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High performance among auto suppliers is plainly no accident. High performers pick the right markets to be in by determining which businesses offer the most attractive growth opportunities in terms of likely returns and strategic fit. They then pursue profitable revenue growth rigorously and systematically, across products, markets and customers. M&A is an important tool for growth, although not to gain scale for its own sake and not at the expense of solid organic growth. Meanwhile, maintaining operational efficiency demands excellence at all points of the supply chain, from product development to sales and bid management processes. ■

### About the authors

Umar Riaz is the managing partner for the Accenture Automotive industry

group in North America. Based in New York, he consults on a wide range of topics, including corporate strategy, sales and marketing, product development and operations. Before joining Accenture, Dr. Riaz worked in product strategies at Ford Motor Company. Dr. Riaz, a post-doctoral fellow at Harvard University, holds three US patents in the area of materials science.

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