give them some credit!

a survey of the barriers to funding the UK's automotive supply chain

By Andy Rumfitt

THE SMITH INSTITUTE

The Smith Institute

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Published by the Smith Institute

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Foreword

Paul Hackett, Director, The Smith Institute

This timely and important report is based around a unique in-depth survey of 82 automotive firms operating at all levels in the UK supply chain and employing 18,500 workers. It shows that despite the economic gloom, there is a prodigious 'window of opportunity' to create thousands of new jobs in the fast growing automotive supply sector. Expanding the sector will not only support further development of the UK's multi-billion pound motor industry, but also make a significant contribution to re-balancing the national economy and boosting growth in under-performing regions. However, as this report makes clear, that potential is currently being thwarted by a serious lack of finance, notably from the banks who on the whole have a poor understanding of the sector. The survey, interviews, company profiles and case studies offer a unique insight into what is holding back the sector and provide an evidence base for a more positive dialogue between the automotive supply chain, vehicle manufacturers, the financial community and government. In light of the report's findings, the author offers a package of practical recommendations, including proposals to enable more finance for tooling, better training, and improvements to government backed schemes.

This work is a follow-on from the previous report 'Gearing up: getting more growth capital into the UK's automotive supply chain', December 2011. Both projects have been undertaken in collaboration with the Society of Motor Manufacturers and Traders (SMMT), which acts as the voice of the motor industry. The Institute is grateful for the support of the SMMT, and I would especially like to thank Paul Everitt, the Chief Executive of the SMMT and Konstanze Scharring, Head of Public Policy and Vehicle Legislation, for their guidance and advice as well as their colleagues Yung Tran and Kate Owen.

We would like to acknowledge the excellent work of the author Andrew Rumfitt, who is a research fellow of the Smith Institute. Andrew has been diligent and meticulous in his research and pulled no punches in recommending a step change in the way both government and the financial sector approach the automotive supply industry. Finally, I would like to thank Andrew Johnson of EEF for his comments and Paul Hunter, the Institute's Head of Research, for editing the report.

Executive Summary

Executive Summary

This unique study of 82 automotive firms and their suppliers covering 18,500 employees (and case studies) shows that despite the recession there is a one-off 'window of opportunity' to expand the sector and potentially create thousands of new jobs. Around 60% of the firms surveyed aspire to grow in the future, one third rapidly. Growth of small to medium sized local automotive suppliers will help re-balance the economy and kick-start growth in places like the West Midlands.

The vast majority of the UK's automotive suppliers hope to secure more long term business on the back of significant new investment by OEMs such as Nissan, Jaguar Land Rover and General Motors. They need funds quickly for new factories and tools to supply the major export-led car producers.

Despite the market opportunities and the desire to grow (half of the firms surveyed want to raise extra funds to expand their businesses), the UK's automotive suppliers, especially firms with less than 500 staff, are being starved of the finance they desperately need.

The study identified five main barriers that must be overcome:

1. The relationship between the banks and the automotive sector. The financial sector on the whole has a poor understanding (and often some disinterest) in automotive suppliers, especially small firms at the local level. Many suppliers are unhappy about arrangement fees, poor service, and complain that the banks will not lend without personal guarantees (often involving their house as security).

2. A gap in growth finance for firms in the automotive supply chain, showing that a long term problem has still not gone away. Credit conditions and terms of borrowing have worsened for more than a quarter of automotive firms. More firms now have to fund growth from their internal cashflow. Many firms are unable to raise enough finance for growth from banks.

3. A particular problem for firms is securing finance for tooling development costs. Only one in five firms surveyed were successful in securing finance for tooling in the last year.

4. Improving the flow of money across the automotive supply chain including the relatively under-developed use of supply chain finance in the sector and, for

example, ensuring that payment terms and conditions cascade down the supply chain.

5. The nature and preferences of owner managers of smaller and medium sized firms. Some owner managers need to take a broader view of ways to finance their firms and improve their investment readiness.

While a range of initiatives undertaken over the last three to four years has helped, fundamentally the banks and Government are not moving as quickly as they need to support the UK's rapidly expanding automotive sector. There is a need to catalyse the process. A need for support and finance to be developed and delivered much more like the highly efficient and responsive car production lines that now operate in the UK. A need to move at the speed that international export markets are now developing. So what should be done?

1. A step change in the engagement of the UK financial sector with the automotive industry is needed. This will require a fundamental change in how the banks undertake their activities at the local level and the speed at which they operate. Reforms should include more dedicated local banking staff with deep specialist knowledge of the local supply chain, a database of automotive experts so that the SMMT can run local 'Meet the Banker' events and, building on the positive steps taken by Jaguar Land Rover and Lloyds TSB, increase the manufacturing and automotive knowledge amongst bank staff on an on-going basis.

2. The Government should take a more strategic and joined-up view of the sector and bring together the ever expanding list of financial initiatives. Schemes, like the Regional Growth Fund, are helping, but funds still take too long to reach firms, most of the initiatives are overly complex, and the sector is unconvinced that a competitive bidding process will strategically unblock the UK's growth bottlenecks.

3. A combined finance and OEM/automotive industry 'Tooling for Growth Taskforce' needs to identify innovative solutions to some of the particular problems with this critical type of investment as well as ways to stimulate the increased use of supply chain finance in the sector.

4. There is a need to move on from a stream of short term public-private initiatives developed in response to the financial crisis and recession to permanently put in place an increased range of enduring and professionally managed finance options

for the long-term backing of the UK's automotive firms, many of which are family run.

5. Some owner managers need to actively identify and assess the expanding range of funding options available to support their firms, supported by independent financial advice where they lack internal capacity.

Section 1

Introduction

1 Introduction

1.1.1 A key objective of the SMMT is sustaining and developing the UK's automotive supply chain. Building on an initial scoping study completed in December 2011 that outlined the main financial and growth constraints affecting the UK automotive supply chain,[1] this in-depth investigation goes further to explore the nature and extent of the specific financing issues affecting the sector. Given the importance of small and medium sized firms to the sector and their local areas, there is a particular focus on problems limiting their ability to access finance to fund their growth plans and tooling costs. This study is timely as the UK's automotive sector is currently experiencing significant export driven growth. With a sluggish recovery affecting the UK this is a rare prize that must be grasped. But the 'window of opportunity' to create jobs, grow the sector, and at the same time help rebalance the economy, will not be open forever.

1.1.2 Completed between March and May 2012, 82 automotive firms operating at all levels of the supply chain in the UK were surveyed: from a firm with 38 plants worldwide to firms with less than five employees. Detailed case studies were completed by interviewing the owners and senior managers of 11 automotive firms (including three UK-based OEMs[2]) and by tracing a specific commodity down an OEM's supply chain. A range of financial experts was interviewed including discussions with three of the largest business banks operating in the UK.

1.1.3 After considering the recent recovery and potential for future growth of the UK's automotive sector, the report identifies the financial issues affecting automotive suppliers: relationships with the banks; a gap in growth finance; problems in funding tooling development costs; payment and finance across the supply chain; and the nature of SME owner managers. The report then concludes with key findings derived from the research and suggests a number of recommendations for the future. Additional results from the survey, a case study of a commodity supply chain for Nissan and finance case studies are included in the appendix.

1 The Smith Institute - Gearing Up: Getting More Growth Capital into the UK's Automotive Supply Chain - December 2012

2 Original Equipment Manufacturers are car producers such as Nissan, Jaguar Land Rover or General Motors.

Section 2

Export driven growth of the UK's automotive sector

2 Export driven growth of the UK's automotive sector

2.1.1 While car manufacturing levels are yet to return to pre-recession levels, in 2011 UK vehicle and engine production continued to drive growth with increases in both output and exports. Some 1.47 million vehicles were produced in the UK in 2011, an increase of 5.1% over 2010. Accounting for about 11% of the UK's goods exports and operating in 100 markets worldwide, the sector recently posted its first quarterly trade surplus in cars since 1976. At £6.1 billion, the value of car exports in the first quarter of 2012 exceeded imports by £561 million, an increase of 20% compared to the last quarter of 2011. The volume of cars exported increased by 22% in the first quarter of 2012 while imports rose by 6%. As a result the UK's automotive sector is a key part of the UK economy and typically generates around £50 billion in annual turnover, delivering around £10 billion in net value-added to the economy.

2.1.2 The automotive industry in the UK already accounts for over 719,000 people employed across manufacturing, retail and aftermarket sectors with about 145,000 people directly employed in 3,200 automotive manufacturing firms and their suppliers.[3] It is, however, a sector where a majority of employment remains in small and medium sized firms (SMEs). More than 52% of employment in England's automotive manufacturing is in firms with less than 500 staff (76,300 jobs) but these make up nearly 99% of all firms in the sector. In common with many industrial sectors a small number of large firms (less than 50 in total) provide the balance of employment (69,500 jobs).

2.1.3 This growth is likely to continue to be driven, in particular, by the expansion of Nissan and Jaguar Land Rover (the UK's leading car producers). Demand for JLR's Evoque has recently doubled. At the same time output of the Nissan Juke has increased from 67,000 to 180,000 units. And production of Nissan's Qashqai is now approaching 300,000 units each year. While UK car manufacturing peaked in 1972 at 1.92 million units,[4] it is likely that over the next five years UK automotive production could achieve a new record high.

2.1.4 This sector's export growth and a desire for local sourcing from the OEMs offer a significant 'window of opportunity' for automotive suppliers based

3 SMMT - Sustainability Report – 13th Edition – (2012). 2011 data.
4 Over the last decade the highest output was 1.65 million units in 2003. However, the UK is only the fourth largest car producer in Europe with four times the number of vehicles being produced in Germany and 50% more cars being produced in both Spain and France.

in the UK and the potential for significant multiplier effects which could benefit many local areas across the country. As about 7.5 other jobs are supported by each job on a UK car assembly line there are potentially major economic and employment benefits to be gained from the expansion of the UK's indigenous automotive supply chain. And for commodity suppliers this demand is not just limited to the automotive sector. There is also increasing demand (known as the 'ramp up') in the defence and aerospace sector which employs 86,700 people in England and has a turnover of £22.4 billion.[5]

2.1.5 The UK's automotive supply chain is benefitting from a number of conditions which support its growth. These include a beneficial exchange rate, the impact of increasing oil prices on transportation costs, the comparative geographical advantage of the UK, increases in the UK's supply chain capacity and the return of previously off-shored jobs through new inward investment.

2.1.6 However, this 'window of opportunity' will not be open forever. The OEMs will have to source components for the lifetime of new models, often six or seven years, regardless of the capacity of the UK's supply chain to deliver. Additional logistics costs from Europe will have to be absorbed and the actual production volumes may have to be limited. As a result, OEMs increasingly work closely with their suppliers to ensure they can expand their capacity in time to meet the growing export driven demand. Over a three year period, Nissan has worked with its supply base to expand its capacity from 300,000 units to 600,000 units. One OEM has had to help a plastic moulding supplier to double the size of its factory to meet demand connected to a particular model.

5 SEMTA 2010

Section 3

A dynamic and productive sector in the UK

3 A dynamic and productive sector in the UK

3.1.1 The automotive sector is continually evolving on a global basis with increasing efficiency and new product development. More widely it is suggested that a third industrial revolution is underway in manufacturing: 'Gone are the grimy machines and oily overalls, replaced by highly automated and efficient processes.'[6] The convergence of a range of innovative technologies is driving this change: smart software, novel materials, dexterous robots, new processes like three-dimensional printing and web based services. As the costs of producing smaller batches of a wider variety to meet individual customer demand is falling, mass customisation is seen as the future. And with the increasing build to order of tailored products in the automotive sector the benefits of proximity for a supplier are genuine and increasing (e.g. shorter delivery times).

3.1.2 Productivity is rapidly improving. Some OEMs now produce twice as many vehicles per employee as they did only a decade ago. Nissan's factory, which opened in Sunderland in 1986, is now one of the most productive in Europe. In 1999, it built 271,000 cars with 4,600 people. Twelve years later, in 2011 it made 480,000 vehicles with just 5,500 people – a record for any car factory in Britain.

3.1.3 A whole new market of electric vehicles also beckons. While over £1.3 billion was spent on automotive R&D in the UK in 2010, the strategic shift towards a low carbon economy is forecast to result in excess of £150 billion being invested globally in low and ultra-low carbon vehicle technologies over the next 20 years.[7] As a result, about half of global automotive executives "feel that [in the longer term] the automotive industry could evolve a completely new business model, where existing interrelationships between OEMs, suppliers and dealers could change radically".[8]

6 *The Economist* (21 April 2012)
7 HM Government – Best of British (2010)
8 KPMG's Global Automotive Executive Survey 2011

Section 4

Unprecedented investments in the UK by car manufacturers

4 Unprecedented investments in the UK by car manufacturers

4.1.1 More than £5.6 billion has been committed in investments in UK automotive facilities over the past 18 months creating major new growth opportunities for the UK-based supply chain.[9] While these investments have already resulted in thousands of jobs at vehicle plants, they could lead to further job creation from high-value contracts from OEMs and Tier One suppliers. The UK supply chain has the potential to provide more than 80% of all component types required for local vehicle assembly.[10]

4.1.2 A range of investments announced in just March and April 2012, particularly linked to Nissan and Jaguar Land Rover, will grow the UK supply chain by creating or safeguarding more than 6,000 jobs:

- **Nissan** - More than 400 jobs will be created at its Sunderland factory and 1,600 more across the automotive supply chain, following the confirmation that the new Nissan hatchback will be built on Wearside. Nissan also confirmed production of an all-new hatchback model at its Sunderland facility from 2014, creating 225 jobs at the plant and 900 more in the supply chain. Investment in recent years at the Sunderland plant now exceeds £900 million, and includes the introduction of the 100% electric Nissan LEAF in 2013, the Juke launch, the construction of a battery plant and the replacement Qashqai crossover.

- **Jaguar Land Rover** – It plans to spend an additional £1 billion with UK suppliers over the next four years amid continued global demand for the Range Rover Evoque. This is in addition to the £2 billion supply contracts it awarded to more than 40 UK suppliers in March 2011 and will cover the provision of components, facilities and services to support the Range Rover Evoque production line at Halewood on Merseyside. Also confirmed was the news that a new logistics facility in Ellesmere Port, Cheshire, will open in summer 2012 to support manufacturing of

9 SMMT – 30 April 2012. Investment announcements in 2011 are expected to result in the creation of around 9,900 new jobs, the safeguarding of over 12,000 jobs and investments in facility expansion and new models worth more than £4 billion

10 Currently the amount purchased in the UK equates to 36% of the estimated £7.4 billion of the total purchasing spend of the combined UK based automotive, commercial vehicle and yellow goods (e.g. tractors and construction vehicle) markets

Range Rover Evoque and Land Rover Freelander 2, creating around 300 new jobs.

- **GM** - Vauxhall recently confirmed that it will invest £125 million to produce the next generation Astra and continue manufacturing at its Ellesmere Port plant in Cheshire, creating 700 new jobs. Manufacturing of the new model is scheduled to start in 2015 with the plant running at full capacity on three shifts producing a minimum of 160,000 vehicles each year. Vauxhall will also increase the local supply content for the Ellesmere Port-built Astra to at least 25%, creating further employment locally and across the UK, helping to boost the plant's competitiveness.

- **Unipres** - More than 350 new jobs will be created and 1,250 safeguarded at its Wearside Plant, following the allocation of £5 million from the second round of the Regional Growth Fund (RGF), which was matched with £41m of private investment. More than 50 new jobs will be created in the UK supply chain.

- **Toyoda Gosei** – It plans to create more than 500 new jobs by 2017 at its manufacturing facility in Swansea.

- **Lear Corporation** – It plans to convert the former TRW Valves plant in Washington, Sunderland, into a UK base for body parts production, creating 300 new jobs.

- **Financière SNOP Dunois Group** – It will re-open a factory in Washington, Sunderland, to supply vehicle parts to Nissan. This will involve an investment of £5 million creating 130 new jobs, with plans for further expansion.

- **Calsonic Kansei** – It is investing £15.3 million to expand the product range at its UK North East manufacturing facility, creating more than 140 jobs.

Section 5

A car manufacturer's supply chain

5 A car manufacturer's supply chain

5.1.1 Car producers or OEMs focus is on the stability and performance of its supply chain. The supplier base is closely monitored to detect signs of distress, to mitigate risk and to react to any insolvency situations. While OEMs have good visibility of their supply chain to Tier One, and sometimes Tier Two and Three, it is only when the supply chain is disrupted (e.g. the Japanese earthquake) that dependence on suppliers for very specific but critical components much further down the supply chain becomes immediately and damagingly apparent.

5.1.2 The supply chains of OEMs are component based. Typically the UK supply chain for an OEM will be split by commodity (trim, body and chassis, powertrain and electrical). Electrical components tend to be sourced from the Far East. Sub-frames tend to be sourced locally due to their weight with local assembly of suspension modules. While engines tend to be assembled in the UK, there is limited capacity resulting in JLR planning a new engine plant to support its operations. Exhausts, radiators and cooling systems tend to come from the UK as they do not ship well. Gearboxes come from Germany and Austria. Most trim and bodywork comes from the UK supply base. The tools on presses come from India and China. All bodywork stamping for JLR takes places in the UK. An example is given of a supply chain for Nissan below and in more detail the appendix.

5.1.3 But over the last three or four years the major suppliers have retrenched. Following the 2008/9 crash many major Tier One suppliers retrenched to their European homelands and consolidated their operations to match the capacity for demand in the market. This acceleration of a longer term hollowing out of suppliers has had a knock on effect at lower tiers in the UK supply chain. OEMs see attracting these European suppliers back to the UK as critical as well as luring major Tier One suppliers based in China, India and South Korea who have sufficient financial resources for the scale of investments required. But the volume of business has to be significant enough to be attractive to an inward investor.

5.1.4 There are current supply opportunities by commodity in the UK. Currently UK-based OEMs' most sought after components include plastic injection moulded components, trim interiors, vehicle upholstery, forgings and stampings. As one OEM noted there is no reason why alloy wheels and satellite navigation

systems, which are currently sourced from Belgium and Portugal, could not be manufactured locally as there is now considerable scale demand for these products in the UK.

Case Study: Commodity Supply Chain (Nissan Driver's Seat)

- The supply chain for a driver's seat for Nissan is relatively complex with 95 components being sourced from 17 different suppliers in 18 different locations in the UK and worldwide. Proximity and guaranteed delivery, often on a daily basis, reflecting Just in Time operations are key attributes of the supply chain.
- The suppliers to Nissan at Tier One and Two are all relatively large international and financially healthy firms with access to capital markets, access to equity funding and sufficient cashflow to finance their own tooling and investment costs. The firms were aware that financing tooling costs does pose problems particularly for smaller firms in the supply chain.
- The Tier One and Tier Two companies also supply other OEMs and major automotive Tier Ones respectively. One Tier Two supplier entered the automotive sector five years ago to exploit its existing capital investment in machinery and leverage its knowledge of tooling.
- After deciding which products it can make and which ones it needs to source in, the Tier One supplier's key criteria for selecting suppliers were quality run rates, risk management, strategic and regional footprint.
- While a Tier Two supplier may be UK-based sometimes volume production of components takes place in Asia or Eastern Europe with only specialist manufacturing and distribution occurring in the UK.
- All Nissan's suppliers have had to be able to increase their production output in line with Nissan's continuing growth and programme of new model development.
- The Tier Two suppliers are often not at liberty to select their suppliers, being required to use 'customer (OEM) directed firms'.

Section 6

A UK supply chain with growth ambitions

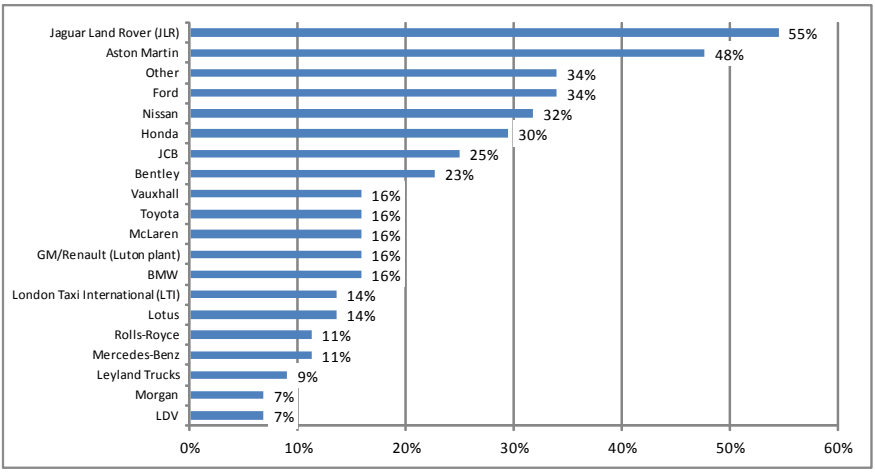
6 A UK supply chain with growth ambitions

6.1.1 So what is the current nature of the UK's automotive supply chain? The survey of 82 automotive firms completed between March and May 2012 for this study covered firms at all stages in the supply chain representing a combined turnover of more than £2.25 billion and operating from 224 locations globally. On average, for these firms, about 80% of their sales are in the automotive sector and 70% in the UK.

6.1.2 These firms had 36 direct supply contracts to UK-based car manufacturers. The most common UK based OEM purchasers were Jaguar Land Rover (55%) and Aston Martin (48%). About one third supply Ford, Nissan and Honda. A wide range of other purchasers were also identified (34%).[11]

6.1.3 The suppliers are diversified. Only one in seven firms has 75% or more of its business with their main customer and more than 50% of all firms have 25% or less of their sales with the main customer. When firms supply more than 50% of the sales to their main customer this purchaser was often Jaguar Land Rover, Nissan, GKN, SAIC (China) or Honda.

Figure1: Main OEM purchasers for UK automotive suppliers (% of firms)

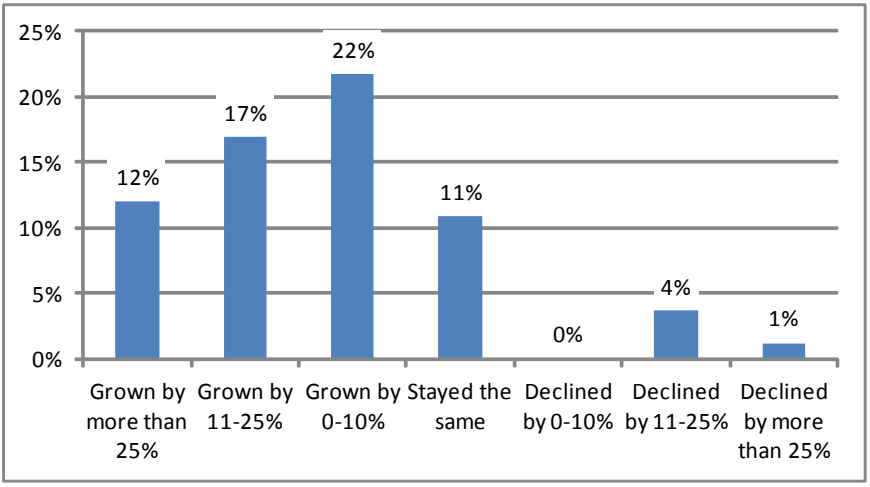


Source: SMMT Survey (March-May 2012).

11 SAIC, Caterham, Calsonic Europe to Nissan, Aisin to Toyota, Cummins, Perkins, IM Group, Mitsubishi, Fiat/Alfa, Mazda, Iveco, Kia, Saab, Subaru, Suzuki, Caterpillar.

6.1.4 More than 50% of automotive sector firms report that they increased their turnover in the last year.

Figure 2: Change in Turnover – Last 12 Months (% of firms)

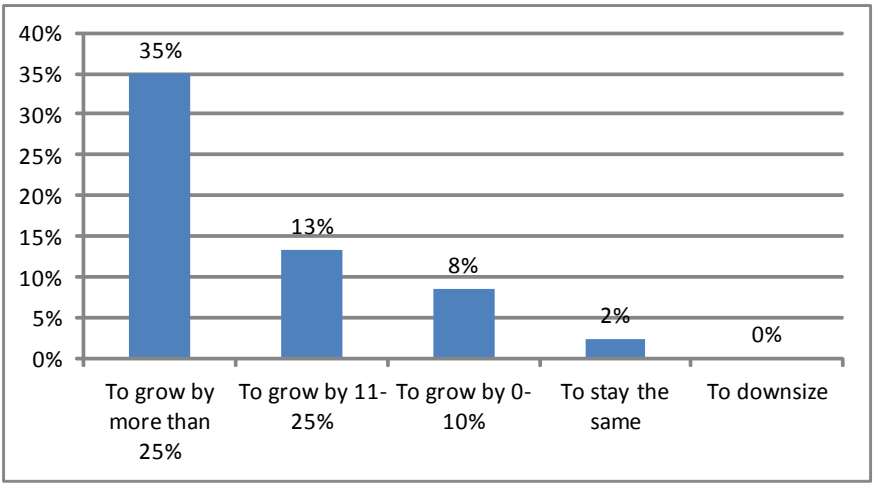


Source: SMMT Survey (March-May 2012). No response 33%.

6.1.5 Nearly 60% of automotive firms plan to grow in the future, one third rapidly. More than one third of firms aspires to grow by more than 25% in the future. Growing sales, achieving an appropriate profit margin on sales and diversifying their customer base were ranked as the most important business objectives by these automotive firms.

"We hold aspirations to significantly develop and grow the size of our business in the future. We plan to extend our reach both in the UK and overseas, especially in the developing BRIC economies where we already have some presence."
"To increase our automotive turnover by 50% over next five years"
"Diversify the customer base by up to 40% of current sales."
"Growth can be achieved through investment in equipment and training. Also larger premises will be required."
"The key objective of the company is to develop non-Nissan business to 40% of our total whilst at least maintaining current business levels with Nissan"

Figure 3: Future Business Objectives (% of firms)



Source: SMMT Survey (March-May 2012). No response 40%.

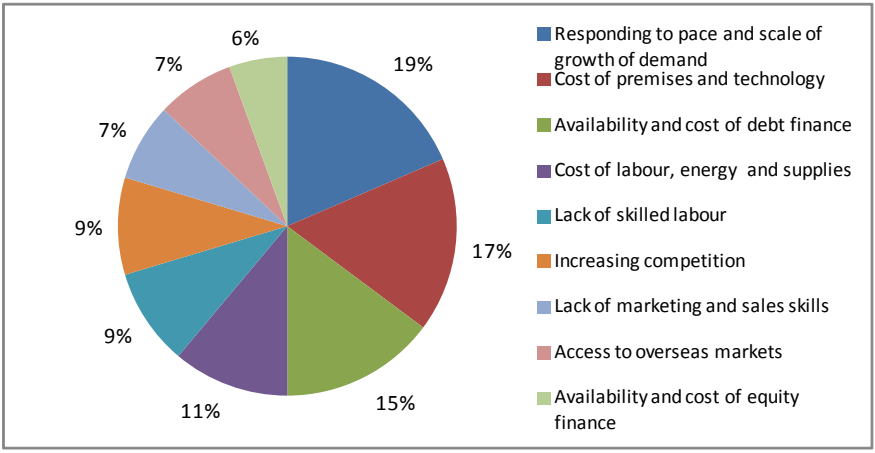
Section 7

Will the UK's 'window of opportunity' be missed?

7 Will the UK's 'window of opportunity' be missed?

7.1.1 So what is stopping the UK supply chain from expanding even more? Automotive firms report challenges in responding to the scale and rapid pace of changes in market demand, the costs of premises and technology and the availability of debt finance. These were identified as the most important issues affecting automotive firms' ability to meet their main stated business objective - growth. Following an era of business drifting away from the UK, a number of OEMs such as JLR and Nissan are doing significantly more business in the UK and have aggressive model ramp-up plans. How firms finance themselves and their growth fundamentally affects the speed at which they can grow in response to these and other opportunities.[12]

Figure 4: Most Significant Challenges to Business Growth (% of Firms)



Source: SMMT Survey (March-May 2012).

7.1.2 **So how do automotive firms finance themselves?** Cash flow and debt are the main sources of finance. More than half of all businesses are using their

12 And it is not just the automotive sector. Challenges in managing the supply chain's ability to respond to increasing demand are also affecting other sectors such as aerospace which also form important markets for suppliers to the automotive sector. Plans by Airbus and Boeing to ramp up their airliner build rates to fill record order backlogs are reportedly being threatened by supply chains that are unwilling or unable to invest adequately in production capacity.

cash flow alone (32%) or their cash flow plus debt to finance their businesses (23%). One quarter of firms use any form of equity finance as part of their financing approach, and this is relatively high given the aversion of SMEs to using equity. About 4% of all firms rely on funding from their parent firm (see Case Study of Shakespeare Forgings).

"There is more focus on financing from internal cash flow than three years ago."
"We use FX (foreign exchange) from our parent company as this is cheaper than any alternative in UK or Europe."

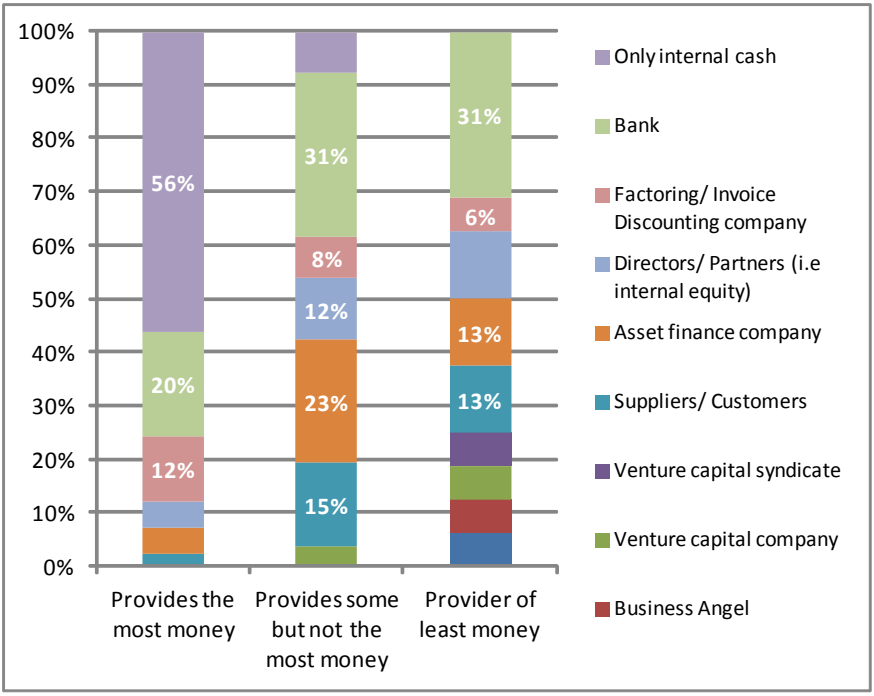
7.1.3 Financial issues are very different between OEMs / Tier Ones and SMEs operating at Tier Two and below. An OEM will have access to international capital markets and the ability to undertake its own rights issues as well as carefully managing its currency exposure across its supply chain. More than 80% of cars produced by Nissan in the UK are exported. The relative cost advantage of sterling, which is expected by the OEMs to last for the next three to five years, is acknowledged as a benefit to UK-based operations. For internationally mobile Tier One suppliers considering different locations the UK's cost base and offer of any tax breaks or grants are compared to other competing locations. As the case study of Nissan's supply chain shows the majority of their Tier Two suppliers are large financially healthy international firms. For UK-based Tier Two and Three suppliers the financial issues relate to cashflow and the payment terms from OEMs and Tier One suppliers. Late payment affects their credit rating and pushes up the costs of credit insurance.

7.1.4 Internal cash (56%)[13] is the most important source of finance for the majority of automotive firms followed by bank loans and overdrafts (20%) and factoring or invoice discounting (12%). Important secondary sources include bank finance (31%), asset finance (23%), finance from suppliers and customers (15%) and equity from Directors and Partners (12%).

"We recently decided that (as many of our customers were on 90 day terms and suppliers were on 30 or 60 day terms) to move banks and move to Confidential Invoice Discounting (CID)"

13 BIS's Small Business Survey (2010) found that of those SME employers looking to grow in the next two to three years, the majority (66%) were planning on funding this growth entirely through internal funding sources.

Figure 6: Most Important Sources of Finance (% of Firms)



Source: SMMT Survey (March-May 2012).

Case Study – Shakespeare Forgings Limited

Shakespeare Forgings is a 26 person forging company with an annual turnover of £4.5 million operating largely as a Tier Three supplier. About £2.5 million of its turnover results from the production of safety critical forged parts at its Cradley Heath site. Four hammers forge steel heated to 1,200oC into 0.4kg to 20 kg parts such as tow hooks, exhaust flanges (for Honda) and other linkages. The remaining £2 million comes from global sales of parts supplied by its Indian parent company, El Forge, which is based in Chennai with 350 staff. Customers are from the rail, shipping, agricultural and automotive sectors, including low volume after-sales. Tooling costs can be up to £12,000 and lead times can be as long as 12 months to reach Start of Production (SOP). The tools (dies) that Shakespeare use (tend to) wear out after producing 40,000 to 50,000 pieces and then need re-cutting. Tooling generally can only be financed out of its cash flow. In addition to labour and energy, the firm's main input costs are steel. The key business objectives are to ensure stability and improve their margins. In common with the industry, the firm has an ageing workforce.

As well as an overdraft, the firm finances its business with invoice discounting, letters of credit and there is a charge on the plant. However, finance has been a problem for

Shakespeare Forgings over the last few years. Its bank's relationship manager "seems to have little authority to make decisions, little understanding of the business and never visited". Placed in 'intensive care' by its bank three years ago, Shakespeare Forgings had to pay a premium for this service as well as £8,000 for a business review carried out at the Bank's insistence which "gave the firm nothing of value". The firm's finance charges are now around £100,000 a year covering overdraft charges, hire purchase, administration charges, credit insurance and interest charges. With their overdraft reduced over time Shakespeare Forgings has been financed by its Indian parent on softer payment terms and in an "incredibly honourable way".

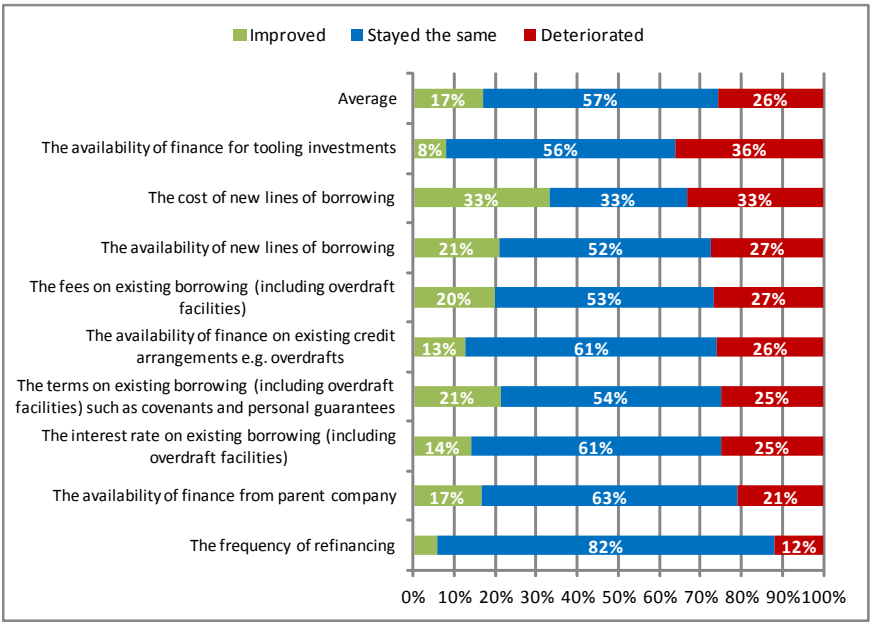
Section 8

Constrained finance continues to limit growth

8 Constrained finance continues to limit growth

8.1.1 Our survey found that, despite the growth in the sector, over the last year financial conditions across a range of measures have actually worsened for more than one quarter of automotive firms. Problems were most acute in securing finance for tooling investments.[14] While, on average, the survey found that financial conditions had improved for 17% of firms, they had deteriorated for 26% of all automotive firms. So for about every two firms reporting an improvement in their financial conditions, three report a decline and seven stayed the same.

Figure 7: Finance - Changing Costs, Terms and Conditions over the last 12 months (% of Firms)



Source: SMMT Survey (March-May 2012).

8.1.2 The greatest change was reported in the costs of new lines of borrowing. While one third of firms reported that these had improved, one third reported that these

14 A machine tool is a machine for shaping, forming or machining car components and often uses a bespoke tool which has to be developed for specific car models.

had worsened over the last year.[15] More than one third of all firms (36%) reported that the availability of finance for investments in tooling had worsened in the last year (with only 8% reporting an improvement). About 27% of firms reported more expensive fees on existing borrowing including overdrafts[16] and a worsening in the availability of new lines of borrowing. One quarter of firms reported a deterioration in the terms connected to existing borrowing.

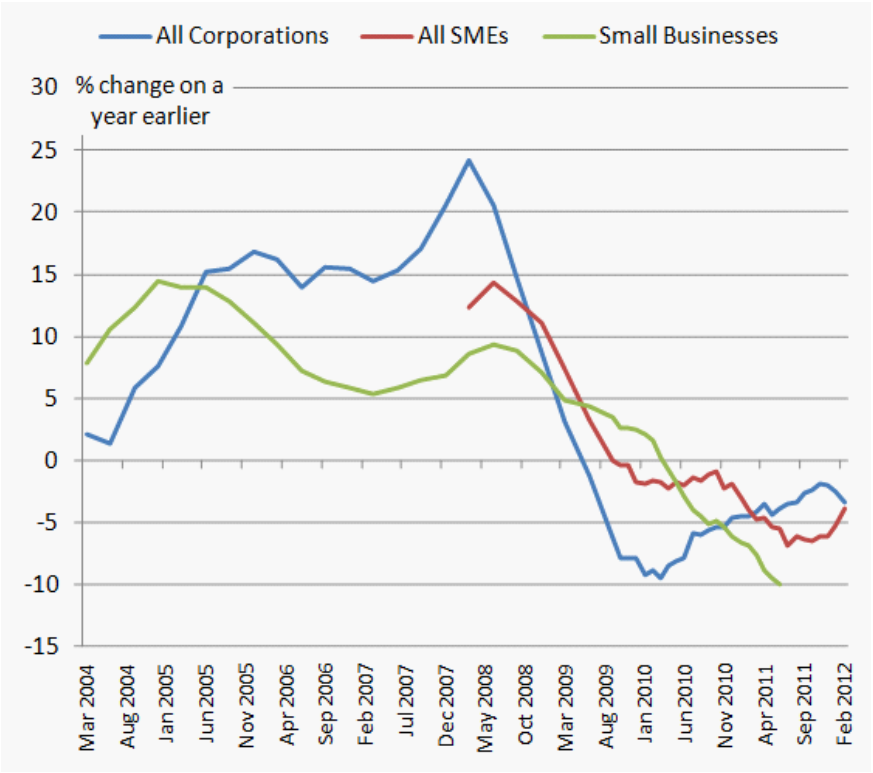
8.1.3 In response to problems with finance availability, some OEMs have supported the cashflow of their smaller suppliers by paying invoices faster. In some ways OEMs are being forced into increasingly performing the role of banks by providing cash headroom for their suppliers and some upfront payments to help with tooling costs. This in turn affects the OEMs perspective about the role and commitment of banks to the UK's automotive sector. Conversely, while an individual OEM's capacity and willingness affects the cash headroom it will provide to its suppliers, some interviewees noted that OEMs (or perhaps Tier One suppliers) could and should fulfil this role more than they do currently.

8.1.4 There is little other evidence of any improvement in the availability of credit to businesses in the UK. The most recent data from the Bank of England[17] report that the stock of lending to businesses decreased by around £9 billion in the three months to February 2012 as part of a more general reduction in financial flows. This results from both restrictions in the availability of finance (supply) and the willingness of companies to borrow (demand). The net monthly flow of lending in February was at its lowest in almost two years. While lending growth rates for SMEs had been stronger than for businesses overall during 2009, this probably reflected their relative lack of access to alternative sources of finance such as capital markets. Lending growth for all SMEs has been negative since late 2009 and has been below that for all corporations[18] as a whole since March 2011. Furthermore, a recent survey by the Federation of Small Businesses[19] found that more than three-quarters of the 3,000 companies surveyed rated credit availability as poor or very poor. More than 40% of applications for credit in the

15 These results are in line with findings for the wider manufacturing sector. In quarterly surveys by the EEF on average 31% of manufacturing firms reported a significant or moderate increase in the costs of finance in each quarter since the end of 2009 rising to more than 37% of firms for new lines of borrowing.
16 Capital adequacy rules have tightened, including higher capital ratios and new specific rules on risk weightings on SME loans and overdrafts. The impact of these rules is likely to fall disproportionately on smaller businesses which tend to be riskier and have higher risk weightings attached (Breedon Report March 2012)
17 Bank of England: Trends in Lending (April 2012)
18 Private Non Financial Corporation (PNFC)
19 FSB: Voice of Small Business Index Q1 2012.

preceding three months were declined compared to just 10% in 2007. On their part, banks report that demand for credit from SMEs remains muted.

Figure 8: Lending to Small and Medium Sized Firms: 2004 – 2012[20]



Source: Bank of England, BBA, BIS and Bank calculations.

8.1.5 Concerns with low levels of lending to business have resulted in a number of initiatives over the last two years. Established in July 2010, the Business Finance Taskforce set out a range of actions 'to help business thrive and grow'. Involving the main UK banks, the Taskforce has focused on making

20 Rate of growth in the stock of lending. Non seasonally adjusted. Growth rates prior to September 2009 are presented on a quarterly frequency and monthly thereafter. All SMEs from monthly BIS survey and bank calculations (lending by four UK lenders to enterprises with annual bank account debit turnover less than £25 million covering both sterling and foreign currency). Small business from BBA (lending by seven UK lenders to commercial businesses with an annual bank account debit turnover of up to £1 million in sterling only. This survey ceased in June 2011).

improvements in 17 areas. Critics suggest that the overall emphasis has been too much on demand side factors - how firms can put themselves in a better position to allow banks to invest in them - rather than also addressing the clear supply side problems at the same time.

8.1.6 A further step, finalised in February 2011, was Project Merlin which set gross lending targets for the banks. Under Project Merlin, the UK's five biggest banks agreed to make £76 billion of credit available to SMEs, but these (gross) targets were missed by £1 billion. Critics highlight that as well as the targets not being met there was no definition of gross additional lending.[21]

8.1.7 A recent Government response (to concerns about the cost of finance) is the new National Loan Guarantee Scheme (NLGS). This scheme aims to pass on a one percentage point reduction in the headline interest rate on loans to SMEs by the Government guaranteeing up to £20 billion worth of loans. However, critics point out that only £5 billion is available over the first six months, the scheme has no targets and it is not compulsory.

8.1.8 Given these evident problems in the availability of finance from banks, the recent Breedon Report (March 2012) examined the increased role that non-bank finance could play in financing the needs of firms, especially smaller firms. The report recommended a range of initiatives to introduce more competition into the supply of business finance as well as stimulating a demand for a broader range of finance from firms. This also reflects wider concerns about the level of competition in the UK business banking sector. The four largest banks provide about 85% of lending to SMEs and the state-owned RBS alone has about a 30% share in the commercial and corporate markets.

8.1.9 As well as issues with the availability of credit for the automotive sector the survey, detailed case studies and expert interviews for this report, found a number of specific financial issues constraining the growth potential of the UK automotive supply chain, especially its smaller and more medium sized firms. Resulting from the nature of the automotive supply chain, current financial conditions and characteristics of an SME supplier these include:

- The relationship between the banks and the automotive sector

21 In March 2010 Vince Cable noted that gross lending targets "would completely let banks off the hook"

including a persistent personal guarantee culture.

- A gap in growth finance for firms.
- A particular problem in securing finance for tooling development costs.
- Payment terms across the supply chain and the use of supply chain finance.
- The nature and preferences of SME owner managers.

Section 9

The relationship between banks and the automotive sector

9 The relationship between banks and the automotive sector

9.1.1 Our interviews with the major UK banks and financial providers highlighted a range of issues that affect their appetite for lending to the automotive sector: the impact of the 2008/9 crash; structural issues in the sector; cost of capital for banks; and the customer segregation and service offer approaches that banks use.

9.1.2 The banks noted that during **the 2008/9 crash** the automotive sector was affected by destocking and the suspension of activities. Late payment was commonplace. The administrative and financial capability of suppliers and customers was tested. The SME suppliers that were more exposed at this point in the cycle were those with limited cash reserves and an overly narrow customer base. But the majority of more viable firms survived. For their part, the OEMs reported that the banks' attitude to the automotive sector can change quite rapidly and they will ratchet down their exposure very quickly. While banks see the sector as risky the OEMs report that supply chain firms tend to become insolvent due to poor financial management rather than price competitiveness issues.

9.1.3 The banks highlighted that there are **structural issues** which affect the financing of automotive firms. There is a lack of debt capacity in OEMs and this is partly related to the extent of their current levels of investment funding their expanding production. Capital investment has a long lead time in the sector. Margins are generally relatively thin (compared to other investment opportunities) and there is high volatility in order schedules. As one bank interviewee put it: you "need deep pockets and a commitment to the (automotive) sector". Another noted that the cost of capital for banks has also become more expensive (even if historically low) so while "commitment terms now tend to be shorter (three-five years), the cost of finance for automotive firms will also be higher".

9.1.4 While one bank, RBS, has a named automotive sector lead others tend to have specialists structured around the type of finance being offered (e.g. Santander has a Head of Asset Based Finance). While many of the firms interviewed as case studies complained about a lack of local or regional presence (and indeed contact) from their banks, some banks do have a regional presence. Operating in Coventry and Birmingham, Yorkshire Bank has a history of lending to the

automotive supply chain and recently provided new facilities to Cabauto (see case study). The Regional Director chairs the Access to Finance committee on the Coventry Local Enterprise Partnership (LEP).

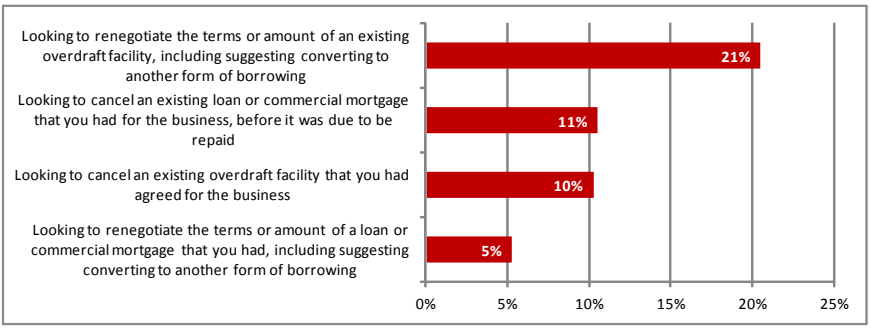
9.1.5 Banks tend to segment their customers by turnover. So for Santander an SME is a firm with a turnover of less than £15 million as well as another £250,000 or less category for small firms, while firms with £2 billion plus are considered corporates. For RBS the customer base is split at less than £25 million for business and commercial and over £25 million turnover for corporates. In the West Midlands, many automotive customers have turnovers around the £5 million mark rising to £25 million - "a nice band of good quality firms" as one banker noted.

9.1.6 Our interviews found that banks generally aim to have a holistic relationship with a business customer covering term loans/debt, revolving credit or overdrafts for working capital, asset finance, support for capital expenditure cycle, invoice finance and international trade (e.g. letters of credit). A range of products can be brought together for a single customer. Some banks suggested that tooling costs were easier to address when they are part of a wider package of financial products. If a bank had a good understanding of an entire business, such as variations in sales due to seasonality, they were in a position to be more flexible. However, most banks do not have a specific product for tooling finance. In contrast, other financial advisers reported that to get the 'best deal' an automotive supplier will generally have to access funds from a much wider range of providers than a single bank.

9.1.7 For their part, automotive firms and manufacturing firms more generally, have concerns about banks' behavioural practices around lending, and this affects their perception of the financial sector. Our survey found that about one in five firms reported that their bank or financial provider had approached them to renegotiate the terms of an existing overdraft. For about one in 10 automotive firms their bank had looked to cancel a loan or commercial mortgage before it was due to be repaid or to cancel an existing overdraft facility.[22] Other reported issues included banks using a technical breach of a covenant as an excuse to charge a larger fee, covenants with unreasonable terms and requirements for firms to be profitable on a monthly basis.

22 This is about double the rate (5%) for all SMEs for Q1-Q3 in 2011 as reported in the SME Finance Monitor (BDRC Continental).

Figure 9: Bank Behaviour in Last 12 Months (% of Firms)



Source: SMMT Survey (March-May 2012).

"Lloyds bank asked to renegotiate our overdraft facility requesting that the director personally guarantee the whole of the overdraft"
"NatWest removed our overdraft facility without explanation or warning. We survived (just) in spite of the cash flow shock and now bank with Santander"
"The bank discouraged an application to refinance existing loans over a longer period as it was implied the refinancing would not be granted even though the company is profitable. The bank was happy to propose invoice financing as an alternative."
"The bank chose to reduce existing overdraft facility due to a reduction in the valuation of our current premises"

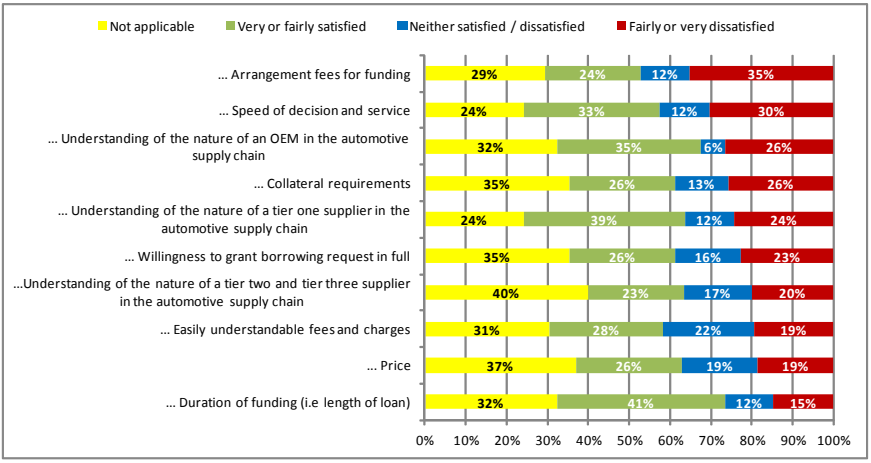
9.1.8 One specific issue that concerns many automotive suppliers is the development of a persistent personal guarantee culture. Following the 2008 crash, banks increasingly started to ask for personal guarantees for loans, even 90% loans for investment in plant and equipment (which offer a form of security). Owner managers were left with the decision of either signing a personal guarantee (which often involved offering their house as security or 'skin in the game') or risk losing their company and livelihood. While many firms reluctantly signed, our interviewees reported that four years later it is still nearly next to impossible to obtain a loan without a personal guarantee. Our interviewees suggested that the pendulum had now swung too far and normalisation was needed. So, for example, firms that consistently meet profit forecasts should be treated differently to firms that don't. This also reflects the generally accepted conclusion that before the financial crisis it was too easy to obtain credit and so some adjustment was appropriate and necessary. Overall, for automotive firms that are looking to invest to expand the continuation of this blanket personal guarantee culture is seen as

a major constraint on their operations and a lack of commitment to the sector from the UK financial sector.

"Banks are not financing companies for even modest investments (under £100k) and will only lend money (for any amount) with a personal guarantee – no way!"
"We were not prepared to provide personal security in addition to business assets"

9.1.9 Reflecting these issues, our survey found that automotive firms tend to have fairly highly polarised views of their main financial provider. On average 30% of firms report that they are very or fairly satisfied with a range of service and price measures, while 24% of firms report that they are very or fairly dissatisfied. Only 14% are neutral on the issue (and it is not applicable to about one third of firms as they utilise internal cash or parent funding to finance their firms). Automotive firms are particularly unhappy about arrangement fees, the speed of decision and service and understanding of the supply chain, primarily issues related to securing additional finance for their firms. OEMs will often just give a supplier six weeks to confirm that are able to fulfil an order so any loan decision would have to meet these automotive industry norms.

Figure 10: Satisfaction with Financial Providers (% of Firms)



Source: SMMT Survey (March-May 2012).

"We always conduct an annual review with our bank. We have had a new relationship manager every year for the last five years"

9.1.10 A persistent complaint of OEMs and automotive firms is that banks, particularly at a local or regional level, have a poor understanding of the automotive sector and the operating relationships. The sector is often inaccurately seen as "oily and unsophisticated". There is a lack of automotive knowledge and local sector experts in banks and guidance on credit is provided from London which is in "another world compared to the rest of the UK". As one automotive firm noted "in the good times too much credit is given. In bad times banks behaviour is dictated by targets and they would have to be brave to go against the guidelines of their credit committee".

9.1.11 OEMs are concerned that the long-term supply relationships which provide the investment context for supply chain companies are not fully appreciated by the banks. As both automotive suppliers and their banks have experienced downturns in the past, investment in a new factory to double productive capacity has to be evaluated carefully by all parties. However, any inherent uncertainty is offset, to a degree, by the long product cycles of the OEMs which often last seven years, including the after-market sales for components. This gives a relatively long timescale for the return on investment and a degree of surety so a supplier who, assuming a good delivery performance, has a supply contract for the life of a product.

9.1.12 As most parties accept that working relationships between the automotive and financial sectors could be better various initiatives have been taking place. In January 2012, Jaguar Land Rover took the relatively unusual step of briefing 22 bankers in detail about their UK expansion plans for plants in Solihull and Wolverhampton. The aim was to help JLR's suppliers to receive a more favourable hearing when seeking loans to expand their production and to buy new machinery and tooling. At the time JLR had issued more than £2 billion worth of supply contracts for the Range Rover Evoque to more than 40 companies in the UK, was investing around £1.5 billion a year in new products and increasing its three Midland plants to 500,000 vehicles a year. Our interviews confirmed that the finance community welcomed the opportunity for a two way dialogue.

9.1.13 A number of banks aim to do more for SMEs. Lloyds TSB reports that it is lending more to SMEs with a net lending target for their SME base. Santander has developed a breakthrough programme focussing on SMEs with a turnover of £50 million or less and has taken 10 SMEs on a trade mission to Brazil. Lloyds TSB has used the Warwick Manufacturing Group to train and accredit its managers with greater sectoral knowledge.

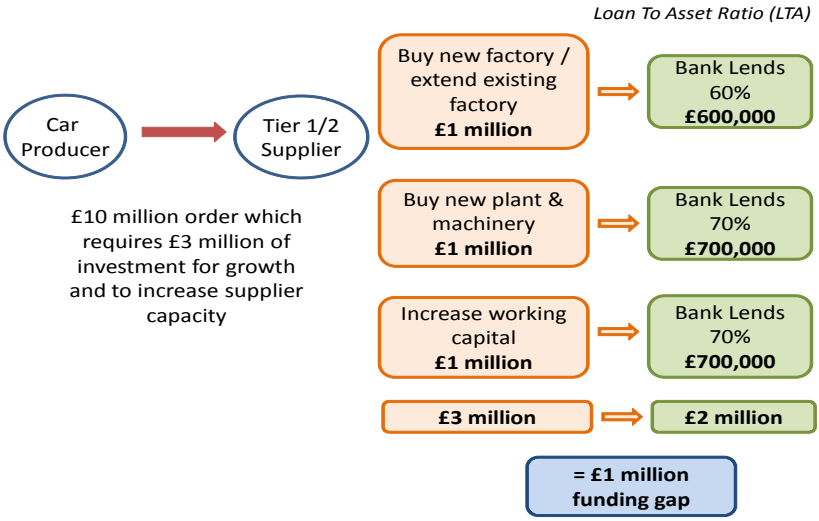
Section 10

A finance gap for automotive supplier growth

10 A finance gap for automotive supplier growth

10.1.1 Our research, interviews and case studies suggest that for a small or medium sized automotive firm looking to expand and invest in its operational capacity there can often be a funding gap (or at least a funding gap in affordable finance). And this has been a persistent issue.[23] To respond to a major lifecycle product order an automotive supplier may well have to invest in a new factory, new plant and machinery as well as additional working capital (see Case Study of Cobra UK). The bank or financial provider will often apply different loan-to-asset ratios to each element. Only about 60% of the value of a new or extended factory might be lent. About 70% of the value of specialised new plant and machinery might be lent, rising to 80% or 90% if the machinery is more generic. About 70% of the required increase in working capital might be financed to cover items like extra inventory or the debtor book. If a firm is able to increase these loan-to-asset ratios the costs of the loan will increase. The result, in our stylised example, is that the firm is missing one third of the funding they require.

Figure 11: Example of Funding Gap for Supplier Growth



Source: SMMT Expert Interviews (March-May 2012).

23 This is not a new issue and most recently the Rowlands Report (2009) investigated the availability of growth capital for SMEs in the UK and found a permanent gap in the provision of growth capital.

Case Study – Cobra UK

Established in 2002 and with sales of £15.6 million, Cobra UK is a maker of specialist automotive parts, employing 137 people across three sites: Whitchurch in England and Welshpool and Wrexham in Wales. Cobra manufactures interior car parts for some of the world's leading motor manufacturers including Bentley, Volvo, Audi as well as Vauxhall, owned by General Motors. Winner of the Queen's Award for Industry in International Trade in 2011, the firm has been growing rapidly with turnover doubling every year since 2006 driven by high levels of exporting to Europe, Canada and Brazil and by diversifying their sales base. The firm secured a £12 million contract with Vauxhall Motors in December 2011 to supply vehicle interior load floors for the new Vauxhall Astra. This marks a considerable reversal of fortunes from 2005 when the MG Rover collapse resulted in the firm losing 90% of its sales.

Searching for £300,000 to finance a £1.5 million factory expansion Cobra had to make use of a special form of funding only available in Wales as part of a scheme financed by the Welsh Assembly (the Repayable Business Finance scheme). Cobra UK was unable to find a bank which lent this amount on acceptable terms. Despite the desire to triple the size of its factory and quadruple its workforce, the firm also found the planning system to be slow and unbalanced in the importance given to environmental issues compared to economic growth and job creation.

Cobra UK has also experienced problems with financing tooling costs with the upfront payments for tooling development not aligning with the payments from its customers. As a result Cobra UK has to finance the costs of tooling internally for about 18 months. In contrast, Cobra UK noted that competitors in countries like Taiwan and China are provided with low cost loans to replace machinery and as a result no machine tools are more than five years old. While Cobra UK recently swapped banks from HSBC to Santander there are largely under-whelmed by the services they have received.

10.1.2 As a result for many automotive firms there is no longer a single financing solution with a blend of sources required. Our interviews suggested that while banks would like a holistic multi-product relationship with automotive firms, in reality a blend of finance from a number of different sources is often required to secure finance for growth and reduce any funding gap. So to raise £2 million a firm may need four different types of finance perhaps from three different providers to access the quantity of funds required at a competitive cost. A property mortgage specialist might be used for the factory expansion. A sale and leaseback arrangement can be used for the plant and machinery. A bank might provide invoice discounting and the firm

might secure a loan under the Enterprise Finance Guarantee (EFG).[24] A corporate finance expert operating in the West Midlands noted that "they had not done a single source financial arrangement for three years" indicating the need for firms to be able to identify and access the best financing package for their firm.

10.1.3 Another issue in financing growth is the relatively limited use of external equity finance reflecting a much longer term issue. Automotive firms suggested that significant external equity investments are very rarely an option. In general, the returns achieved in the automotive sector are not high enough to attract external equity investment[25] which often looks for compound annual growth rates of 20% to 25%. On the demand side, SMEs can have a strong aversion to giving up a stake in their business or offering a seat on their board to outside investors.

24 The Enterprise Finance Guarantee facilitates additional bank lending to viable SMEs lacking adequate security for a normal commercial loan. The Government provides the lender with a guarantee for which the borrower pays a premium. Accredited lenders administer EFG and make all decisions on lending.

25 There have been some specific initiatives to help with equity raising. InvestBX was set up by Advantage West Midlands in 2007 with the aim of helping SMEs to raise up to £2 million in equity finance from private investors who can use the online platform to trade shares. Just three companies have listed and the exchange has "had a muted welcome from the local investment community."

Section 11

Problems in funding tooling development

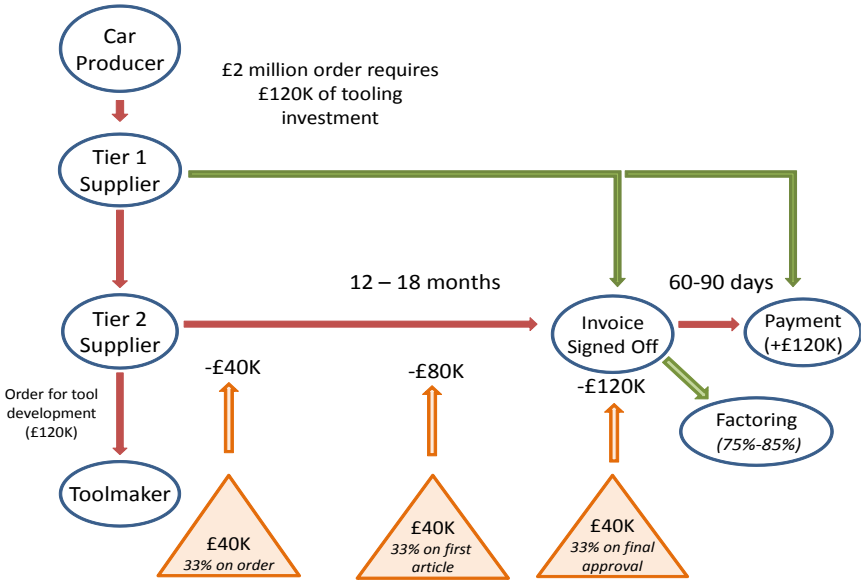
11 Problems in funding tooling development

11.1.1 A machine tool is a machine for shaping, forming or machining car components. The processes can involve cutting, boring, grinding, shearing or other forms of deformation. Machine tools generally employ a tool or mould that does the cutting or shaping. Tool making involves making the customised tooling that is used to produce the car components for specific models for Tier One suppliers and OEMs. Common tools include metal forming rolls, lathe bits, milling cutters, and form tools. A die[26] is a specialised tool used in manufacturing industries to cut or shape material using a press. Due to the unique nature of a tool maker's work, it is often necessary to fabricate custom tools or modify standard tools. The customised tools and dies generally remain the property of the OEM as they are linked to a specific component for a model and as an insurance against the risk of a supplier becoming insolvent. In preparing to supply components for a new model, a supplier therefore has to invest in advance in the development of new tools and sometimes additional machinery for the tools. The costs of tools vary by the type of component being produced and the life of the tool.

11.1.2 The need for tooling finance relates to the timing of costs for tooling development and when payment for the components (including their tooling costs) occurs. A growing Tier Two component supplier may need to invest £120,000 in tooling to service a £2 million order with a Tier One supplier who is, in turn, responding to a new model programme for an OEM. The development cycle may last 12 to 18 months before the final sign off of components by a Tier One supplier. Typically the supplier has to make three phased payments to the toolmaker during the tool production process. However payment from the Tier One for the components (and this includes the tooling costs) will generally not occur until 60 to 90 days after the components produced by the tools have been accepted. While factoring can bring this payment forward (at a cost), when tools are purchased from Asia between 50% and 100% of the costs may need to be paid up-front. A specific issue for many small and medium sized automotive firms is how to finance this process of tooling development. A failure to do this is a key barrier constraining the expansion of SMEs in the UK automotive supply chain (see Case Study of Cabauto).

26 See Shakespeare Forgings Case Study

Figure 12: Example of Financing Tooling Development Costs



Source: SMMT Expert Interviews (March-May 2012).

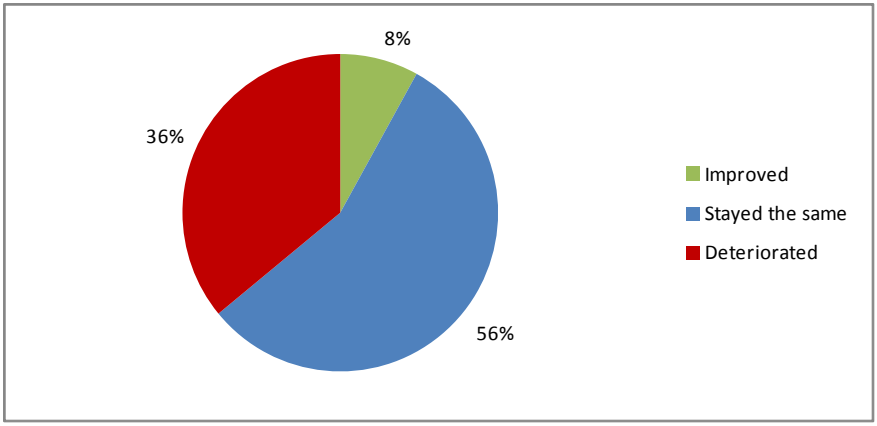
11.1.3 Our survey of automotive firms shows that over the last year, a period of high growth for the UK automotive sector, finance for tooling has been a particular problem for smaller and medium sized automotive firms in the UK. For every firm reporting an improvement in the availability of finance for tooling more than four reported problems in accessing finance to support tooling investments. Less than one in five firms that applied for finance to support tooling development was successful in the last year with 'lack of security' being the most common barrier.

11.1.4 In response firms, where they can, have to finance tooling costs from a much wider range of sources compared to other investments and general business finance. For example, sources of finance for tooling include asset finance,[27]

27 A recent EEF survey (May 2012) of the manufacturing sector found that almost 60% of firms have bought assets in the last three years to boost productivity or to reduce energy consumption. Almost 70% of firms used internal funds to finance the asset purchase for fear of taking on debt and uncertainty over the costs of finance. Demonstrating a change in the lending landscape the use of asset finance outstripped traditional loans when external finance was used - a key reason was the long term or known full cost of the finance.

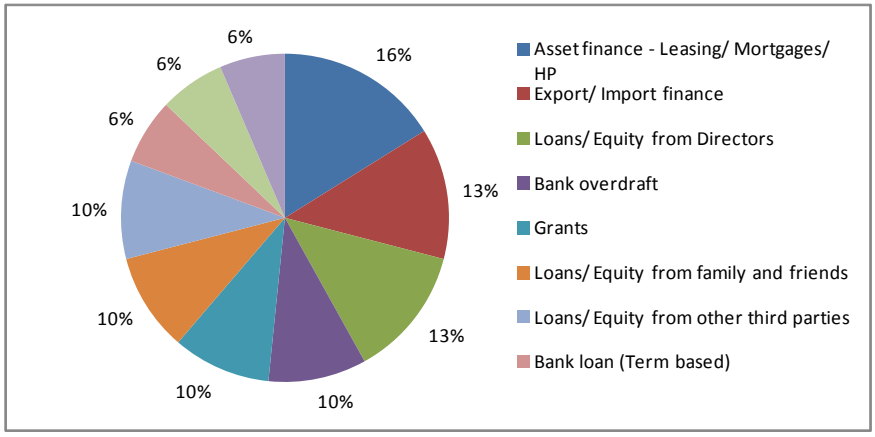
export/import finance, bank overdraft, grants, loans and equity from family, friends and third parties. In contrast, the main sources of general business finance are overdrafts, invoice finance and loans or equity from Directors. Other capital expenditure is being primarily finance by grants, asset finance, bank loan and bank overdraft.

Figure 13: Availability of Finance for Tooling: Change over last year (% of Firms)



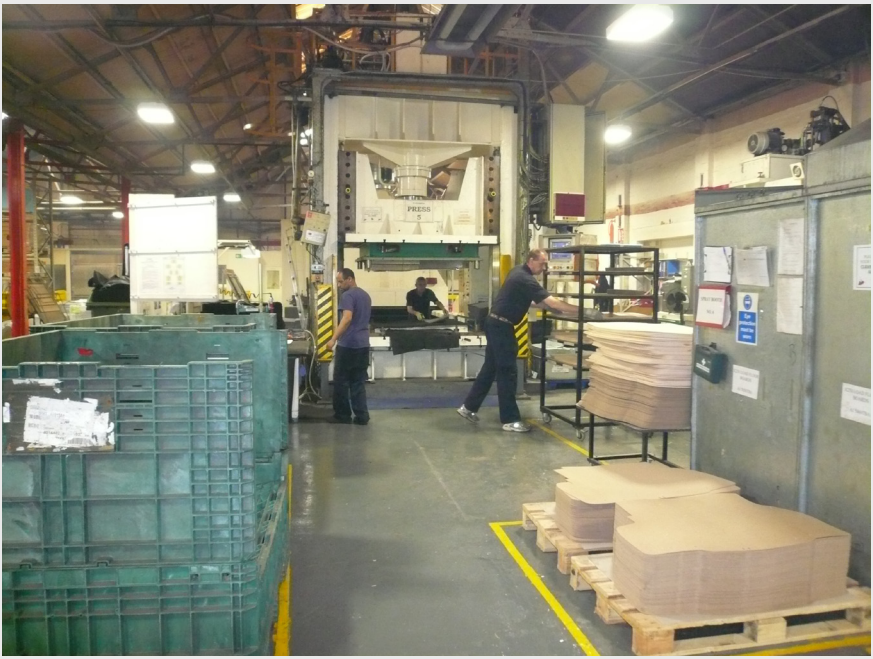
Source: SMMT Survey (March-May 2012).

Figure 14: Sources of Finance for Tooling (% of Firms)



Source: SMMT Survey (March-May 2012).

Case Study – Cabauto



A Tier One supplier to Jaguar Land Rover, Cabauto has grown from 56 staff in 2005 to 230 employees with turnover now approaching £20 million. The firm could expand further as the potential output capacity from its current site is £40 million and there is a potential pipeline of £15 million of orders but crucially this depends on capital investment of £1.7 million.

Cabauto principally manufactures car interiors and has numerous production processes including composite sandwich structures, foam moulding, powder coating, welding, cutting and sewing and waterjet cutting. A wide range of components are produced for both car manufactures and Tier One suppliers: seats for the Defender; trim for the Jaguar XF; carpet trim for Aston Martin; arm rests for Toyota; sun visors for McLaren; and gear gaiters for Honda. Cabauto has been actively scouting out much higher volume opportunities to supply European firms like Audi, VW and Skoda. After nine months the firm has been accepted as an approved supplier and aims to secure some business in the next six months.

Securing finance has been a continual challenge since 2005 when the company was formed. Established following the demise of MG Rover, Cabauto was formed by buying a former Lear firm out of administration which made seats for the Land Rover Defender. With the acquisition of two other firms, production was consolidated at a single site in Tipton in the West Midlands. With "no chance of bank financing" for the firm, the Advantage West Midlands Advantage Transition Bridge Fund[28] provided a soft loan to the firm to finance tooling investment. JLR was also very supportive of the initial formation and have provided softer funding terms by paying invoices in seven days. The long term close working relationship with JLR is "second to none" with detailed monthly reporting and visits every three months.

Following the 2008/9 crash JLR suspended production resulting in stockpiling and payments being delayed for up to six months. At this time GE Commercial removed their banking facilities from Cabauto due to one missed VAT payment. A further £250,000 was provided from the Advantage Transition Bridge Fund and JLR also offered payments on seven day terms rather than 30 - 60 days. Cabauto has now fully repaid the loans to ATBF Fund.

Securing funds for tooling investment remains problematic for Cabauto. A new assembly line (jig and fixture and associated software) was required to produce the seats for the Land Rover Defender - a 50 year old vehicle. The cost of this investment was £300,000 but Cabauto was only able to raise £60,000 in finance from banks due to the asset valuation approach used. The banks valued the plant and equipment at £100,000 (in situ) and just £30,000 (ex situ or fire sale value) despite the line of work potentially generating £10 million a year in sales for Cabauto, about 50% of the firm's turnover. Only the Advantage Transition Bridge Fund was able to provide finance to support the investment.

Cabauto is now planning its tooling investment for the Jaguar X152 which is replacing the XK. The cost of the tooling suite is £822,000 with a further £704,000 for a range of tooling supplies. The challenge for funding tooling developments of this nature is the difference in payment timing for the tooling and from the car manufacturer paying for the supplied components. Tooling development costs are typically paid 30% on order, 30% on delivery of the tool and 40% when the parts are passed off. However, the automotive supplier will not be paid for its components perhaps until 12 to 18 months later (plus 60 to 90 days). As a result, a firm like Cabauto has to finance £600,000 of

28 Loans of between £50,000 and £500,000 were considered for SME businesses based in the Midlands which had a viable business plan but were unable to secure finance to progress that plan from normal commercial sources due to restrictions in the conventional credit market.

costs over 12 to 18 months to be able to invest in its capacity to supply parts to JLR's new models. Cabauto has recently been able to secure a £200,000 interest only loan from Yorkshire Bank who made a number of visits to the firm but this represented just a third of its required funding. Letters of credit are also used as the tooling suites are normally sourced from Germany and China. Another opportunity to supply BMW will require £600,000 of capital expenditure and £300,000 of tooling but could generate £5 million in sales.

11.1.5 While financing tooling development is acknowledged as a problematic area by both the OEMs and the banks, what are the causes? There are a number of issues at work here including: the valuation of the tool by the banks, the actual ownership of the tools and a 'poor fit' with normal automotive finance resulting in what appears to be a general aversion to lending against tooling investments.

11.1.6 As ownership of the tool generally rests with the OEM, on default the bank would recover the machine but not the tool, which would revert back to the OEM. Banks generally want to be the owner of an asset on default. This issue also affects the residual value that a bank places on the asset and thus the amount it will lend to an automotive firm.

11.1.7 Financing tooling development costs does not fit with the way most automotive funding is delivered. The bulk of finance comes from bank overdrafts together with Confidential Invoice Discounting (CID) and factoring (which is a disclosed credit control facility). Many banks actually preclude tooling from being financed from invoice discounting and supply chain finance is not an obvious solution to this issue.

11.1.8 OEMs are aware of the problems with financing tooling development costs with suppliers having to finance the costs for periods of 12 to 18 months. OEMs believe that the banks overestimate the risks involved in default as they do not fully appreciate the importance of the suppliers to the OEMs. Typically most contracts with OEMs allow them to break the relationship at just a week's notice but they rarely would. By holding the tools a supplier is in a (short term) ransom position especially if they are a single source supplier. So it is very much in the OEM's (or their Tier One's) interest to ensure its supplier does not default on any loan. The impact of stopping a car assembly line is extremely high, especially where speed to market is key.

11.1.9 Our discussions with the banks found that issues around the title for assets such as tooling are generally dealt with on a case by case basis. For a 'good supplier' banks suggested there was scope to look more at the "performance aspects of the risk". And some firms have been supported with tooling. For example Lloyds TSB supported Premier – manufacturer of panels for the Evoque and the Olympic Torch - with its tooling costs through a mixture of hire purchase, leasing and working capital.

11.1.10 The banks also said there was potential to look at the security values of the assets based on the ability to repay and the viability of the business. For example, the ability of an OEM to remove their tooling and install it with another supplier would improve with the residual valuation of the asset and thereby increase the loan-to-value ratio for the supplier.

Section 12

Supply chains and their financial flows

12 Supply chains and their financial flows

12.1.1 A smooth and rapid flow of money down the supply chain is one way to improve the financing of the automotive suppliers.[29] This generally improves the working capital position of the firm and can assist in providing additional funds for growth. Banks generally felt that it was not uncommon for the terms for automotive suppliers to get worse as you move down the supply chain. Suppliers that were closer to their OEM buyer such as Nissan or JLR were generally much better placed to have a meaningful dialogue with their banks about finance. As one Tier Two supplier noted "the further you are from your final purchaser the less easy it is to sit opposite your bank".

12.1.2 Some interviewees also noted that "some Tier Ones are difficult and OEMs can turn a bit of a blind eye". Commercial confidentiality can affect the ability of an OEM to know the contractual terms and conditions being passed down the supply chain. While OEMs can influence the terms and conditions down the supply chain to a degree it would require joint concerted action with their major Tier Ones to increase the flow of money down the supply chain.

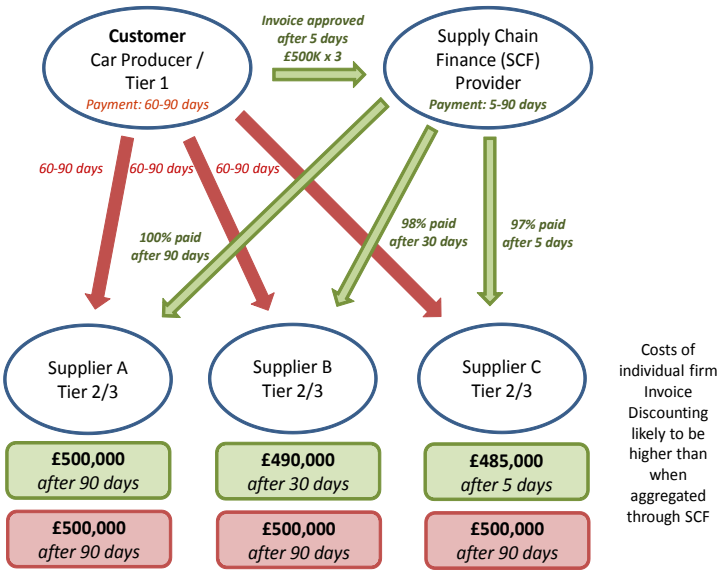
12.1.3 However, prompt payment remains the best way to lower costs within the automotive supply chain. But as the costs are taken on mainly by the buyer some form of discount is normally required to incentivise buyers to pay in advance of contractual payment terms. Supply chain finance is one way of doing this but there are also other benefits. If implemented properly, a supply chain programme involves the streamlining of processes by the buyer and creates a more integrated relationship between buyer and supplier. Our interviewees pointed to other industries (such as brewing and pharmaceuticals[30]) and firms (BT and Network Rail) where supply chain finance was more common than in the automotive sector. However, adoption of supply chain finance models seems to be relatively rare in the UK automotive sector.

29 The Breedon Taskforce noted "that there is significant benefit to be gained from freeing up more of the cash currently tied up in supply chains across the UK economy. Reducing days-receivables would improve cash flow for small businesses and enable them to operate with lower overdraft facilities. Large companies would have correspondingly smaller positive cash balances, but given current low yields the impact on earnings would be less negative than the positive impact on SMEs. Banks would see reduced net interest income, but would require less capital to support overdraft lending and would face reduced funding constraints."

30 For example, chemists can secure funds or guarantees from their large suppliers of pharmaceuticals based on agreeing to an exclusive sourcing deal. More historically the large breweries offered loans to (tied) public houses and recovered the costs by supplying beer at a higher costs (and exclusively).

12.1.4 So how does supply chain finance work? In essence, supply chain finance allows a proportion of invoiced funds to be released earlier on the basis of an approved invoice. So, in our example below, a firm can obtain 98% of its invoice value after five days instead of 100% after 90 days. A third party supply chain finance provider works with the main buyer. There is likely to be a cost reduction to automotive suppliers especially compared to using invoice discounting on an individual basis. The fees for invoice discounting (set-up fee, monthly fee and interest rate) are likely to be higher than the costs of drawing down money through a supply chain finance model. A number of the major banks have supply chain finance products (e.g. Lloyds TSB, Maxtrad from RBS). Some banks (e.g. Santander) offer a one off option of using supplier finance with the option to switch to this as an automotive facility if desired.

Figure 15: Example of Supply Chain Finance



Source: SMMT Expert Interviews (March-May 2012).

12.1.5 There are a number of elements required to make supply chain finance work and issues with each affecting its uptake. Supply chain finance automation is based around a 'host' (e.g. major aerospace, automotive, retail or tele-

communications company[31]), its capacity to provide credit facilities and its ability to control and manage their supply chain. The credit rating of the host is critical to allow payments to fund the working capital of the supplier. Banks will generally look for an "investment grade buyer", though a S&P or similar rating is not a necessity. There were key questions for the banks: Is there an appetite from investment grade OEMs and Tier Ones to give up some debt capacity and apply it to their supply chain? Do the OEMs and Tier Ones have the credit capacity to be a provider of debt especially when they are investing heavily?

12.1.6 Supply chain models generally work well to improve working capital for regular suppliers operating on short terms of around 60 to 90 days. Operating to much longer timescales this is why the financing of tooling development costs sit less well with this model. However, some OEMs are less keen on involving financial providers in their supply chains (e.g. invoice discounting) as it introduces the risk of a third party which can withdraw their services.

12.1.7 Efficient approval of standardised invoices is required and this generally encourages invoice efficiency but visibility of the supply chain is required. However, a characteristic of the automotive sector is that an OEM's visibility of its supply chain is relatively poor past their major Tier One suppliers. Banks want to see end-to-end relationships to be able to assess the risk.

31 A supply chain model adopted and implemented by BT allowed about one third of their suppliers to drawn funds more rapidly.

Section 13

Owner managers of automotive supply firms

13 Owner managers of automotive supply firms

13.1.1 Banks noted that the investment readiness of automotive firms varied quite widely and this went some way to explain the variation in success rates of securing finance. Banks felt that firms without a full-time Finance Director were generally at a disadvantage (and this suggests a high correlation with the size of automotive supplier). The financial literacy of automotive firms and their accountants was seen as important to ensure that they were able to consider all funding options and not act on preconceptions. For example, some banks felt that accountants "ran down the benefits of invoice finance to their clients and saw it is a funding of last resort". Overall as finance packages were becoming more tailored for particular firms and covering a range of loans, overdraft and equity there was often need for independent financial advice.

13.1.2 As has been identified in earlier work[32] automotive suppliers are typically run by engineers with financial matters being more of a secondary focus. However, what our survey also shows is that more than 37% of firms would categorise themselves as family run, bringing in a whole range of family business culture issues. In addition, their financial competence may be underestimated. Nearly 85% of the firms in the survey reported that they had a full time Financial Controller or Financial Director.

13.1.3 The owner manager's attitude to risk, approach to business and any exit plan all affected their approach to financing their firm. However, as one financial adviser noted as "we are in a relatively buoyant phase in the cycle for many automotive suppliers this may be the time to have an exit plan especially [for ageing owner managers]".

13.1.4 One issue is the age old problem of low take-up of external equity investment. However, there are a number of challenges to increasing equity investment in smaller firms beyond concerns about the rate of return that can be achieved.[33] Smaller companies are higher risk and have relatively high transaction costs compared with larger deals offering better returns. There are relatively fixed costs associated with due diligence so a £500,000 deal has similar costs to a £5 million deal which gives a bias towards larger deals. There is too little knowledge and

32 The Smith Institute - Gearing Up: Getting More Growth Capital into the UK's Automotive Supply Chain - December 2012
33 Stephen Welton (CEO of Business Growth Fund) 6 March 2012. While there are around 7,000 fast growing companies with a turnover of £5m-£100m in the UK, there were less than 40 first round growth capital investments of £2m-£10m made in these companies in 2011

awareness of equity alternatives among business owners and a lack of investment readiness. Owners are often wary of equity investors and worried about losing control. Even if control is not ceded, having another person involved in the decision making can slow it down and this perceived negatively. As a result automotive firms may have had an historic over-reliance on debt.

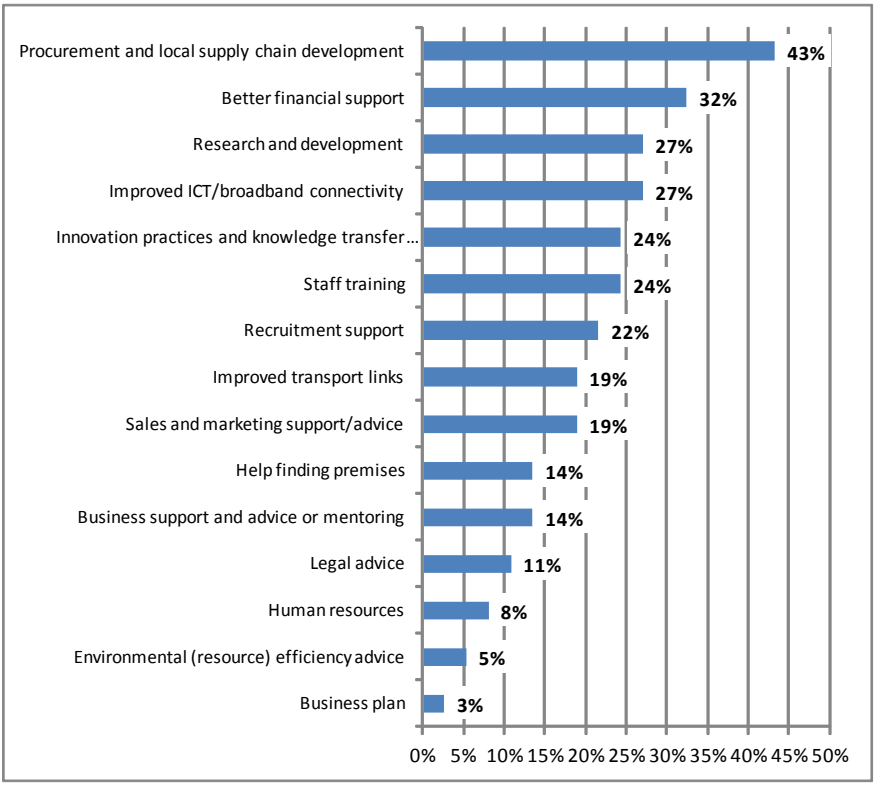
Section 14

UK automotive sector support needs

14 UK automotive sector support needs

14.1.1 So overall what does the automotive sector in the UK most want help with to improve its competitiveness? Our survey found that automotive firms most wanted support with procurement and the development of local supply chains (43%) followed by better financial support (32%), support with R&D (27%) and ICT and broadband connectivity (27%).

Figure 16: Support Needs (% of Firms)



Source: SMMT Survey (March-May 2012).

14.1.2 While the Regional Growth Fund (RGF) has assisted a number of automotive OEMs and larger Tier One suppliers and is now well known, automotive applicants are far from complimentary about the RGF: most notably the

slowness of the process operated by BIS which fits badly with the speed their commercial operations move at; and with a bid threshold of £1 million the fund is mainly targeted at larger firms. However, RGF has been used to increase finance for asset purchases and this is accessed through a number of major banks including HSBC (see case study).

Case Study - Regional Growth Fund - HSBC's Assisted Asset Purchase Scheme
In response to the £1 million threshold for RGF applications, in November 2011 BIS announced that RBS, NatWest and HSBC had agreed to distribute up to £95 million of the Regional Growth Fund to help SMEs invest in new capital assets such as plant and machinery. Under the initiative RGF grants of up to £500,000 will be awarded to SMEs accompanied by bank loans of typically two to five times the size of the grant. HSBC will be lending up to £25 million of RGF as part of its Assisted Asset Purchase Scheme which "enables qualifying businesses to obtain funding towards the acquisition of assets where they would not ordinarily be eligible due to the lack of sufficient stake". Firms need to be an HSBC customer, be creating additional employment and wish to buy an asset but lack a sufficient deposit. The level of grant provided is based upon the size of the business, the level of asset investment and the number of full time jobs created (one job must be created for every £25,000 of grant received). Job creation is confirmed by an independent accountant 24 months after drawdown or earlier if borrowing is repaid. The asset purchase is funded by a suitable HSBC Equipment Finance product and the rate of interest can be fixed or variable. A negotiable arrangement fee is chargeable. The firm is able to choose the supplier of the asset and negotiate as if they were a cash buyer.

14.1.3 Announced in November 2011, the Advanced Manufacturing Supply Chain Initiative (AMSCI) is a new £125 million national initiative[34] to create more competitive supply chains and new employment opportunities. With its roots in a multi-LEP RGF bid, the AMSCI fund has the potential to avoid some of the problems affecting RGF and, with a minimum bid size of £200,000 (for West Midlands applications), could offer more opportunities for smaller firms to secure grants or loans to support their growth and tooling investments. However, the fund has again taken the best part of a year to reach the market and has been split into two mutually exclusive streams. One OEM expressed frustration at the lack of a sectoral approach from the Government who seemed to prefer "to set up a never ending stream of competitive bidding rounds rather than take a more strategic look across the whole automotive supply chain."

34 With an application deadline of 13 June 2012.

14.1.4 In our interviews, some OEMs and automotive suppliers also expressed concerns about skill levels in job applicants and their workforce and the need for re-skilling. There were also problems in recruiting staff with key technical skills (e.g. design engineers) with a highly competitive market for talent (e.g. some OEMs recruiting engineering undergraduates in their second year at university). There was a specific concern that Government policy on skills was not being joined up to meet the needs of the sector. For example, while Academies offer an increased focus on vocational manufacturing skills, the downgrading of the new Engineering Diploma for 14 to 19 year-olds from its current value of five GCSEs to one was seen as a major retrograde step.

14.1.5 From their global operations OEMs are well aware of how different countries have different approaches to supporting their indigenous automotive sector. There is an explicit commitment to preserving manufacturing jobs in France which extends to repatriating back jobs from Eastern Europe. Germany is seen to benefit from a much larger network of regional banks, a lack of market share held by the main commercial banks and a state sponsored investment bank (the Kreditanstalt für Wiederaufbau or KfW[35]) which was identified by some firms as a potential model to help the UK's automotive sector. Banks in the US seem to have a different view of risk in the automotive sector and US banks appear more innovative in their development of products to support the sector – though the much larger market scale is a factor helping this focus on the investment proposition. In general US non-bank lending seems to be a much more developed sector with less of a controlling stake required. While a number of OEMs would like some of the larger European Tier One suppliers to return to the UK competition for internationally mobile automotive inward investment is fierce.[36]

35 Based in Frankfurt KfW banking group is a German government-owned development bank, and its name originally comes from Kreditanstalt für Wiederaufbau, meaning Reconstruction Credit Institute. Formed in 1948 after World War II as part of the Marshall Plan, it is owned by the Federal Republic of Germany (80%) and the States of Germany (20%).

36 One UK based automotive supplier has been offered 0% loans, no tax for 20 years, a VAT rebate for five years and £2 million to relocate to Canada.

Section 15

Key findings

15 Key findings

15.1.1 With increases in both output and exports including the first trade surplus in cars since 1976 the UK's automotive sector is driving growth in the UK.

15.1.2 To support their ambitious future growth plans the major OEMs in the UK (such as Nissan, Jaguar Land Rover and General Motors) are investing heavily in their production facilities, R&D activities and supply chain. While more than £5.6 billion committed in investments in the last 18 months alone, announcements in just March and April of this year will potentially create or safeguard 6,000 jobs in the UK supply chain. The OEMs want to source more locally and can identify additional commodities that could now be produced in the UK, following the contraction after the 2008/9 crash. It has been estimated that up to 80% of the £7.4 billion automotive supply chain purchases in the UK could be sourced locally.

15.1.3 Supported by a number of beneficial conditions there is now a time limited 'window of opportunity' for the UK's supply chain to expand to meet these significant opportunities for business growth. For the UK, as well as export driven growth, the prize is additional manufacturing employment in parts of the country that have suffered most severely in the current, continuing recession.

15.1.4 And the UK supply chain is ready to grow. Our survey of 82 automotive firms (from the very small to the very large), the detailed case studies and the supply chain mapping show firms with a track record of growth and an appetite for growth. As one firm put it; "We hold aspirations to significantly develop and grow the size of our business in the future. We plan to extend our reach both in the UK and overseas, especially in the developing BRIC economies where we already have some presence." Unsurprisingly, automotive firms identified supply chain development and better access to finance as the two key areas where support is needed.

15.1.5 But the growth potential of these firms is being constrained by challenges in responding to the scale and rapid pace of change in market demand, the costs of premises and technology and the availability of debt finance. The size of an automotive firm determines how it can finance itself and its growth. Larger firms like OEMs and Tier One suppliers have access to international capital markets and undertake rights issues. Smaller firms - and 99%

of all UK automotive firms have less than 500 staff - have fewer options to finance their business growth, relying, most commonly, on a mixture of internal cash and bank loans.

15.1.6 However, despite 45% of firms wanting to raise finance to fund their growth and the current opportunity for growth, our survey found that there continues to be a particular problem in the availability and cost of finance. At least one in four automotive firms reported that the financial conditions for their business, as measured across a range of indicators, had deteriorated in the last 12 months. There were particular problems evident in obtaining finance for tooling, a key investment for any automotive supplier that is seeking to service orders for new models from the major car producers and their Tier One suppliers. More than one in three firms reported that the availability of finance for tooling had deteriorated in the last year despite a buoyant sector.

Financial Products: Too Many or Too Few?

The issue seems to be not so much a lack of specific products but rather the terms and costs connected to the existing products, the most competitive blend of products that an automotive supplier now needs to bring together to finance its growth and the range of financial options available in the UK compared to other countries.

- The main business banks offer a whole range of financial products covering overdrafts, term loans, asset finance and mortgages but it is the terms, conditions, costs and loan value connected to these which together determine whether they meet a supplier's financing needs.
- A range of other specialist providers in established (asset finance) and newer sectors (peer-to-peer lending) offer alternatives but while take up in these areas is increasing some owner managers may have a too narrow view of how to finance their business. Additionally, as the Breedon Report noted, some non-bank funding options are much less well developed in the UK compared to other countries.
- While there appears potential for supply chain finance to be used more in the UK's automotive supply chain and the major banks offer products, there are a number of adoption issues that would have to be overcome.
- There is certainly a plethora of national Government backed finance initiatives (the SMMT's current summary guide now runs to 74 entries) as well as more local funding options. But the issue for an SME is finding its way through the financial maze and being able to commit significant time to an application. And

as some of these funds are only accessible through the same banks that have withdrawn finance over the last four years, there is an understandable reticence amongst some automotive firms in applying.

- As reported in previous research, automotive firms consistently want to know which banks are 'open for business' with the automotive sector and have the necessary specialised and local knowledge of the industry.

15.1.7 Why are the UK's small and medium sized firms being starved of finance? Our research found that there were five key factors that went some way to explaining this. Some are new, others are perennial issues. In the round they relate to the current behaviour of banks and other lenders towards the automotive sector (and manufacturing more generally in the UK), the nature of the automotive supply chain, and the characteristics of an SME owner manager.

15.1.8 **The relationship between the banks and the automotive sector.** The automotive sector has a highly polarised view of its financial providers and the relationship is badly damaged. Many automotive firms complained about a persistent lack of understanding of the automotive sector and the nature of its supply chain relationships amongst banking professionals (especially locally) and a lack of local staff with any real decision making power. Banks seem rarely to want to meet with the firms they could finance unless it is to renegotiate their financial arrangements. In the last year, about one in five automotive firms were approached by their bank to renegotiate their overdraft. This often involves its removal or the requirement of a personal guarantee to retain the facility. Originally, a short term measure, this persistent personal guarantee culture was highlighted as a particular problem by many smaller firms and a clear sign of a lack of commitment to the automotive sector in the UK. The owner manager is often being asked to put up his house as 'skin in the game' or risk losing their livelihood.

15.1.9 **A gap in growth finance for firms.** For a firm that wants to grow there is a funding gap due to the loan-to-asset ratios that banks apply across finance for working capital, tooling and capital investment. Our case studies of Cobra UK and Cabauto - with turnovers of £16 and £20 million respectively - show how firms are struggling to finance their growth potential. These firms increasingly have to blend finance from many sources if they can, which is especially necessary to finance tooling, or suffer limitations on their potential expansion. A lack of provision from the lending community means many firms

have to turn to government funding initiatives.

15.1.10 **A particular problem in securing finance for tooling development costs.** A machine tool is the key element for an automotive firm to manufacture components for an OEM or Tier One supplier. As the development costs have to be funded in advance over a 12-18 month period and a low residual value is often given to the asset as the OEM has title over it, the UK's automotive SMEs struggle to raise external finance to fund this critical investment activity. There is also a poor fit with traditional automotive finance (such as invoice discounting and factoring) which operate on much shorter timescales and, often, prohibit the finance of tooling.

15.1.11 **Payment terms across the supply chain and the use of supply chain finance.** A good flow of money down the supply chain is one sure way to improve the financing of automotive suppliers. Much of this is about similar commercial payments terms being replicated from the OEM downwards. However, this is not always the case. Smaller firms more remote from their final buyer are at a disadvantage. As one Tier Two supplier noted "the further you are from your final purchaser the less easy it is to sit opposite your bank". While relatively little used in the automotive sector, supply chain finance models are a more formalised way of speeding up payment and improving the integration across the supply chain. However, there would have to be an increased appetite to take this forward amongst the OEMs and Tier Ones. For their part, OEMs have increasing concerns that they are getting drawn into being banks due to lack of finance from normal lending sources.

15.1.12 **The nature and preferences of automotive SME owner managers.** It is well known that the investment readiness of smaller firms varies widely and this is a factor in different success rates in securing funding. A typical automotive firm is often run by an engineer with only a secondary interest in finance, and the traditional model has been to use internal cashflow with loans and some invoice discounting. However, our survey found that 85% of firms did have a full time Financial Controller or Financial Director suggesting that most firms do have adequate financial knowledge and competence. Our survey also found that at least 37% of firms were 'family run' bringing another dimension into the decision making equation. There is often a general aversion from owner managers in the use of external equity in addition to well known problems in the supply of equity investment to smaller automotive firms given the comparative costs and the rates of return that are achievable.

Financing Issues for Automotive SMEs

Growing medium sized automotive firms like Cabauto and Cobra UK see a number of financing issues affecting their ability to expand in the UK:

- **Lack of finance for growth.** Apart from the £200,000 loan, Cabauto has to finance its own growth which is restricting its ability to seek out bigger opportunities in the UK and European supply chain. Cobra UK could not access banking funding to invest in a new £1.5 million factory and had to use a grant from the Welsh Assembly.
- **Financing tooling costs.** It is very difficult to finance tooling costs from commercial sources. As a result, the growth potential of firms like Cabauto and Shakespeare Forgings is being limited.
- **Valuation of plant and equipment.** There are problems with the approach that banks and the professional advisers use in valuing plant and equipment assets at just fire sale levels (and often not valuing associated software at all). Tools are just not seen as valuable assets of the businesses.
- **Ownership or title of the tool.** As a tool is an asset owned by the OEM rather than the supplier, banks are reluctant to lend against it. While technically they could recover the tool if the supplier failed to perform or went bankrupt the impact on the production line would be significant. OEMs are highly dependent on their suppliers and the long term close working relationship between firms like Cabauto and OEMs like JLR is felt to be under-valued by banks.
- **Purchaser's credit rating.** Banks could pay more attention to the credit rating of the purchaser and have a much better understanding of the nature of the relationship between car manufacturers and their suppliers. This could then be reflected in their lending practices.
- **Equity investment.** The potential of equity investment is very dependent on the nature of the automotive firm. Cabauto has two shareholders with stakes of 85% and 15% each but their time horizons and objectives are different making equity based finance inappropriate. Cabauto has never looked at mezzanine[37] or venture capital finance.
- **Softer loans on commercial terms work well.** Softer loans like the Advantage Transition Bridge Fund (ATBF) have been critical in ensuring the survival and growth of firms like Cabauto. With terms similar to a normal

37 Mezzanine finance is a form of debt which shares characteristics of equity but ranks below senior debt and be particularly helpful for high growth firms. However mezzanine finance is little used in the automotive sector - BIS found that only 1% of UK firms used mezzanine finance in 2010 - even though it removes some of the concerns about loss of control while still having a long term investment horizon.

loan this avoids a grant dependent culture and the funds are self-financing and recycled.

- **Whole business view.** Assessing gearing across the whole business (e.g. covering overdraft, letters of credit and invoice finance) would help firms like Cabauto finance their investments. This would give aggregated borrowing headroom related to current and planned turnover and potentially release more funds for investment.
- **Pressure to adopt invoice financing.** Cabauto is sceptical about invoice financing as it sees it only working when a firm is growing and they see problems in exiting from invoice discounting in the future. Its sees profit as more important metric than sales and a loan benefits from having a known monthly payment.

15.1.13 With their private ownership, family involvement, export focus and importance to local communities, many of the growing automotive firms in the UK have similarities to Germany's much vaunted Mittelstand group of companies although they operate in a less supportive financial environment. These, often quite large, firms (the family owned automation company Beckhoff has 2,100 staff and a €456 million turnover) occupy enviable worldwide leadership roles in many niche markets, including machine tooling and automotive components. However, the simple wholesale adoption of the Mittelstand model to the UK is unlikely to be possible. The model has evolved over many years so manufacturing firms operate in a different ecosystem in Germany with a more diverse range of banks and more local knowledge. While many of these firms are more than 70 years old and others have roots back to the 19th century, their resilience and durability, focus on creating high value and innovative products, positive approach to family involvement and business aims based around long term finance and stewardship (rather than short term profits) offer important lessons for continuing attempts to rebalance the UK economy.

Section 16

Recommendations

16 Recommendations

16.1.1 Drawing from extensive primary research with 82 automotive firms, detailed case studies, expert interviews and tracking a commodity supply chain our research found that many automotive firms, especially the smaller ones that make up the majority of firms in the UK, are being starved of the finance needed for growth. They represent a neglected part of the supply chain relatively badly served by the banks which are limiting the finance available and also by Government initiatives that tend to focus on larger firms. To address these issues and to achieve the UK's growth potential there are areas of action for banks, OEMs and Tier One suppliers, Government, the industry and the SMMT, as well as firms themselves.

16.1.2 While a range of initiatives undertaken over the last three to four years has helped, fundamentally the banks and Government are at not moving as quickly as they need to support the UK's rapidly expanding automotive sector. There is a need to catalyse the process. A need for support and finance to be developed and delivered much more like the highly efficient and responsive car production lines that now operate in the UK. A need to move at the speed that international export markets are now developing.

16.1.3 A step change in the engagement of the UK financial sector with the automotive sector is now required particularly at the local level and in the development of a specialised package of support and products. While a number of banks such as Lloyds TSB, RBS, Yorkshire Bank and Santander show an appetite to better understand and work with the SMEs in the automotive sector this now need to go further and more broadly. A number of actions are recommended:

- Building on JLR's initiative, increase the frequency of two way dialogue between OEMs, Tier Ones and the financial providers who will then be approached for funding by suppliers further down these supply chains.
- The banks that are 'open for business' to identify and train up their own internal automotive experts for the main areas of the UK where there are clusters of the automotive sectors (e.g. West Midlands, North West, North East and Wales). These experts will be able to analyse local lending risk on the basis of a deep knowledge of the automotive supply chain relationships and constant contact with their key local automotive firms.

- SMMT to develop and market a database of these automotive experts and run a series of 'meet the funder' events building on their successful 'meet the buyer' events to allow automotive firms to talk face-to-face with a range of finance providers.
- Through the establishment of a cross-industry automotive 'Tooling for Growth Taskforce', banks and OEMs to explore more innovative solutions that would allow SMEs to access more finance for tooling. This should be a key area of work for the Automotive Council's Supply Chain Group.

16.1.4 There is a clear need to improve the awareness of (and demand for) all types of finance so automotive SMEs have the greatest range of options to fund their growth. There are a number of initiatives that could be taken:

- Implementation of the Breedon Review's recommendations to expand the supply of non-bank finance in the UK. There should be a particular emphasis on support to improve the adoption and adaption of supply chain finance models to help to support growth capital provision in the automotive sector. There is also potential to explore the use of peer-to-peer lending and mezzanine finance in the sector. This could include promotional and learning materials as well as invoicing best practice.
- Increasing the use of asset backed finance as part of a more structured approach to finance and to access a wider range of lending products.
- There is now a bewildering array of government backed financial initiatives with much confusion in the market. These need bringing together under one organisation to improve ease of access for automotive SMEs.
- Establishment of a team of intermediary financial advisers focussing on the automotive and manufacturing sectors to co-ordinate and catalyse public and private lending at the more local level. These could be based the Local Enterprise Partnerships or linked to the national Manufacturing Advisory Service.
- Explore the potential for an automotive finance master class (with a focus on tooling) to be developed and offered perhaps by an appropriate Business School in association with the ICAEW or similar body.

16.1.5 With a lack of bank finance many growing firms have had to seek support from the public sector. However, while Regional Growth Funding has supported a number of OEMs and Tier One suppliers and the West Midlands stream of AMSCI is focussed on the automotive sector, there is a generic need to

improve the design, implementation and operation of these funds. The public sector timescales are still out of step with the speed of the automotive sector. Funds still take much too long to reach firms when finance is needed much faster. Overly complex initiatives are still being designed or heavily managed by civil servants. While some OEMs remain unconvinced that a competitive bidding process for a stream of initiatives will unblock the growth bottlenecks they face trying to increase their sourcing in the UK, the public sector has a mixed track record in investment selection.

- One way forward would be to ensure that successful and easy to use financial mechanisms, worked up closely with industry and the OEMs, become long term financing options for the UK's automotive supply chain rather than merely being one of many short term initiatives. Automotive firms note that professionally managed funds such as the Advantage Transition Bridge Fund worked well in the past.
- Government funds often arrive in isolation from a wide local economic embedding strategy. Expanding automotive firms are trying to recruit skilled staff (especially engineers), upskill their workforce, invest in R&D and obtain planning permission to expand. They need to be handled as key accounts with an integrated and holistic support package as an expanding SME sector will be a key job creator for the UK.
- Investigation of whether it is feasible for any of the Government backed schemes to be able to offer some form of guarantee to a host company (OEM or Tier One) to allow them to establish new supply chain finance models for their UK automotive operations.

Section 17

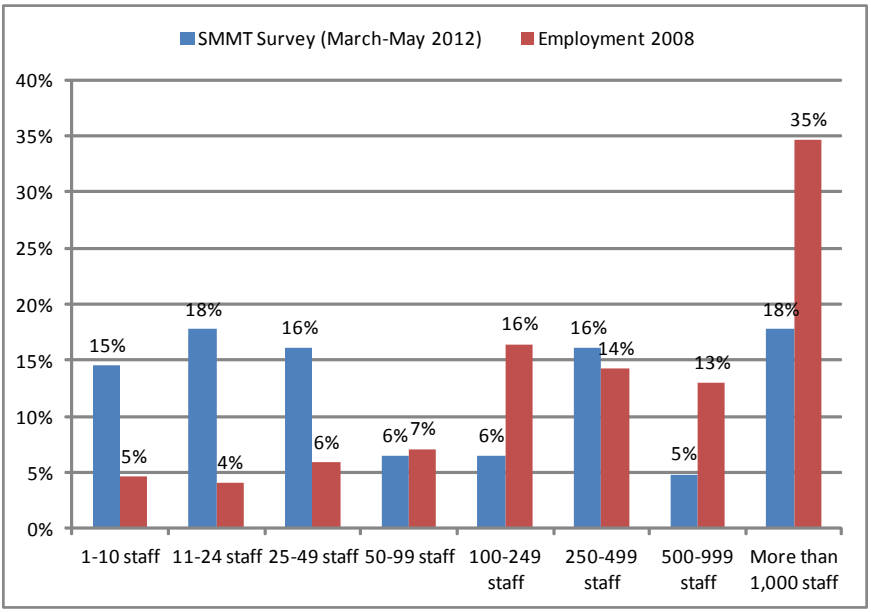
Survey Results: UK Automotive Firms

17 Survey Results: UK Automotive Firms

17.1 Profile of sampled firms

17.1.1 An online survey of 82 automotive firms was completed between March and May 2012. The survey covered firms from all parts of the value chain including OEMs and Tier One, Two and Three suppliers. While the respondents were self selecting and quotas were not used the sample is reasonably representative of the employment across the sector by firm size.

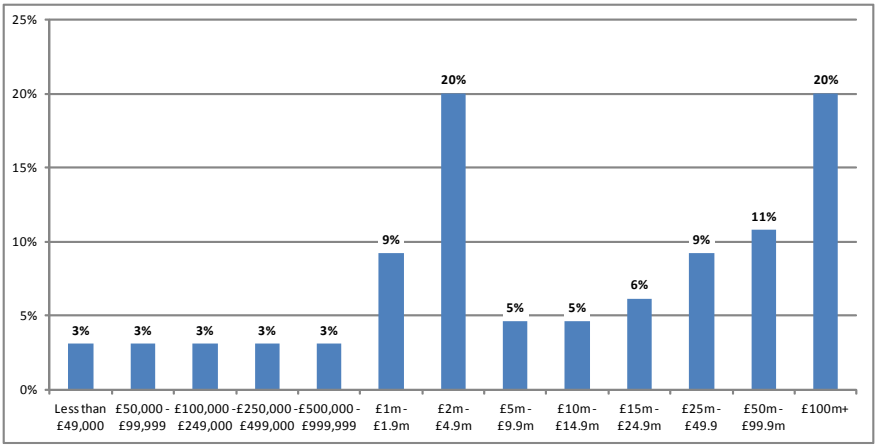
Survey and Automotive Sector: Employment By Sizeband (%)



Source: SMMT Survey (March-May 2012), ONS

17.1.2 In total the firms surveyed were responsible for more than £2.25 billion in aggregate turnover with an average turnover of £35 million. In total these firms operate 224 sites globally, with a median of one per firm (mean was 3.4) rising to a maximum of 37 sites.

Turnover (% of Firms)



Source: SMMT Survey (March-May 2012).

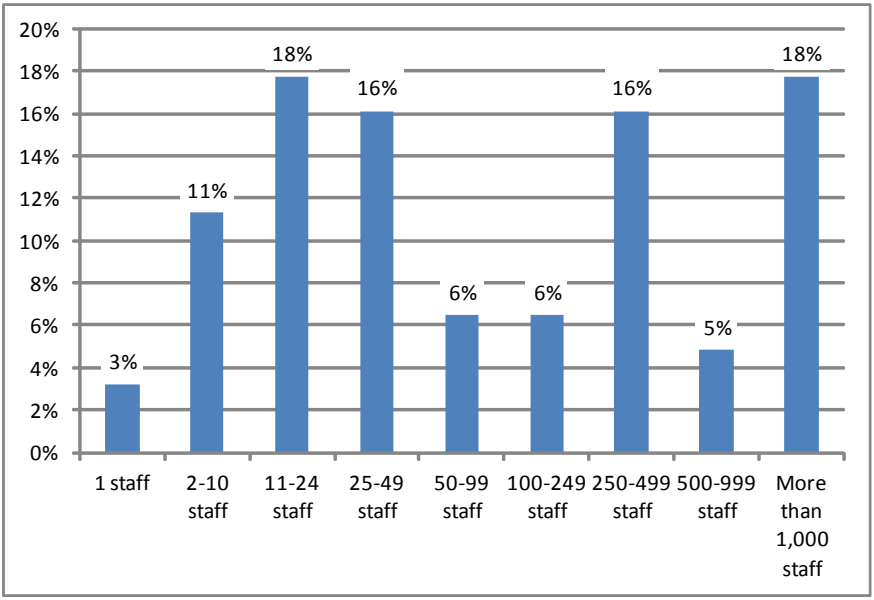
17.1.3 **A wide range of products and services are supplied.** The firms surveyed supplied a wide range of products and services to the automotive sector and end customers.

Products and Services Supplied

Source: SMMT Survey (March-May 2012).

17.1.4 **All sized firms in the automotive supply chain.** The highest number of responses came from small firms (11-49 staff), larger firms (250-499 staff) and very large firms (+1,000 staff). In total the survey covered firms employing more than 18,500 employees across all their global operations.

Employment (% of Firms)

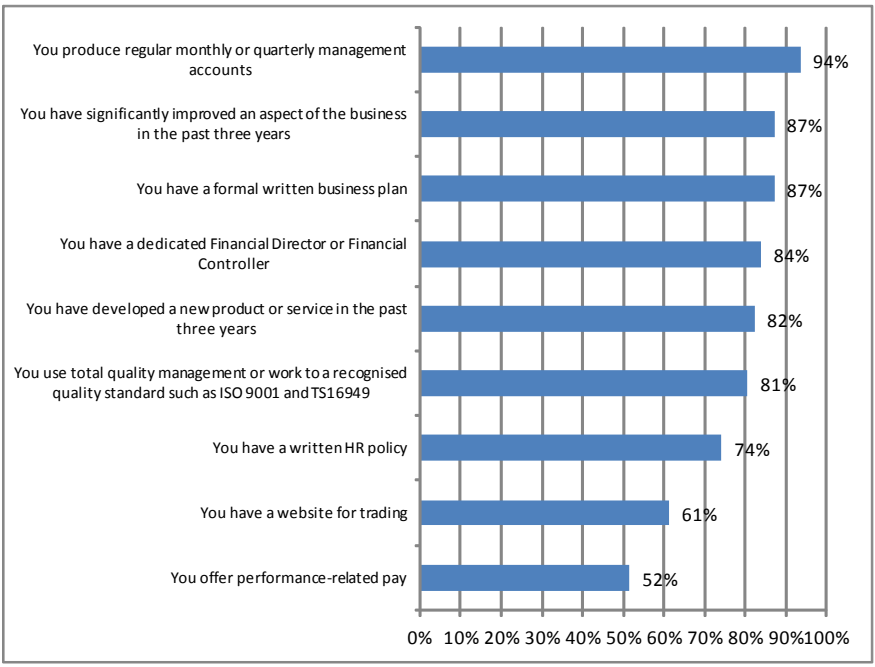


Source: SMMT Survey (March-May 2012).

17.1.5 **More than one third of firms are family run.** Of those responding more than 37% of firms would classify themselves as family run firms, although this may be an under-estimate as one quarter of respondents did not answer the question.

17.1.6 **Financial and management systems are well developed.** About 95% of firms produce regular management accounts and just under 90% have a formal written business plan and have improved their business recently. Just under 85% of firms have a dedicated Financial Director or Financial Controller.

Business Processes and Polices (% of Firms)



Source: SMMT Survey (March-May 2012).

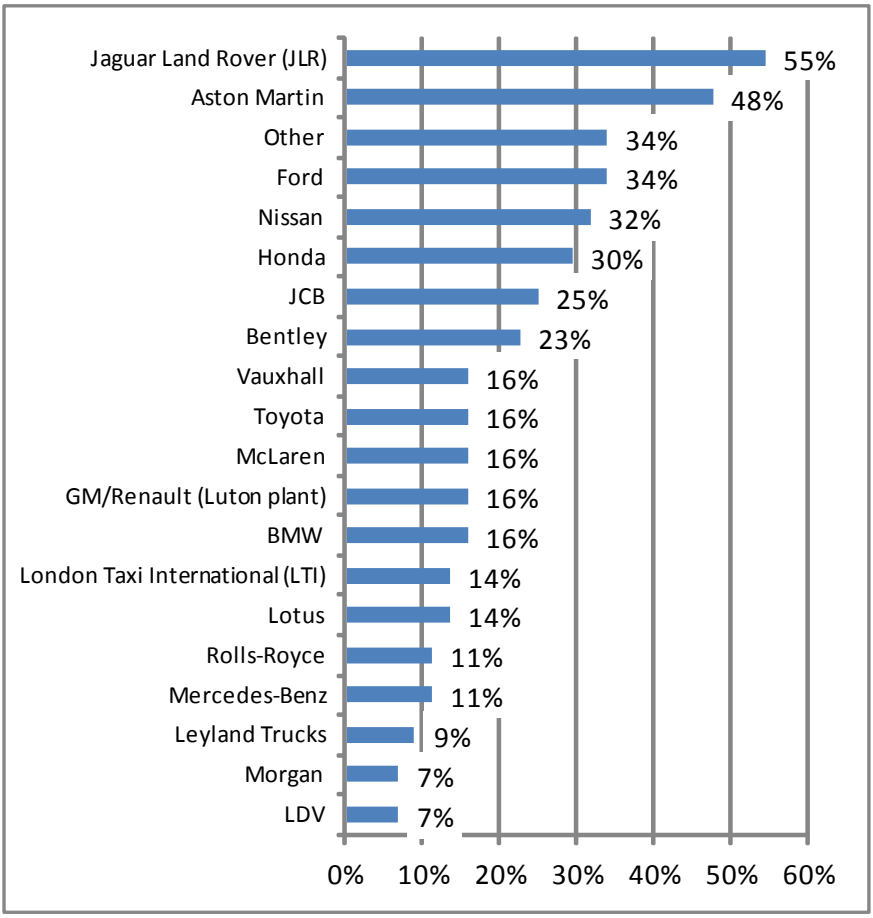
17.2 Customer base

17.2.1 **Sales: 80% automotive and 70% UK.** On average just under 80% of sales were to the automotive sector with 69% of sales to UK based customers and 31% to overseas customers.

17.2.2 **Jaguar Land Rover and Aston Martin are the main purchasers.** Where firms supply an OEM some 55% of firms report that they supply Jaguar Land Rover and 48% supply Aston Martin. About one third supply Ford, Nissan and Honda. A wide range of other purchasers were also identified (34%).[38]

38 SAIC, Caterham, Calsonic Europe to Nissan, Aisin to Toyota, Cummins, Perkins, IM Group, Mitsubishi, Fiat/Alfa, Mazda, Iveco, Kia, Saab, Subaru, Suzuki, Caterpillar, Mitsubishi

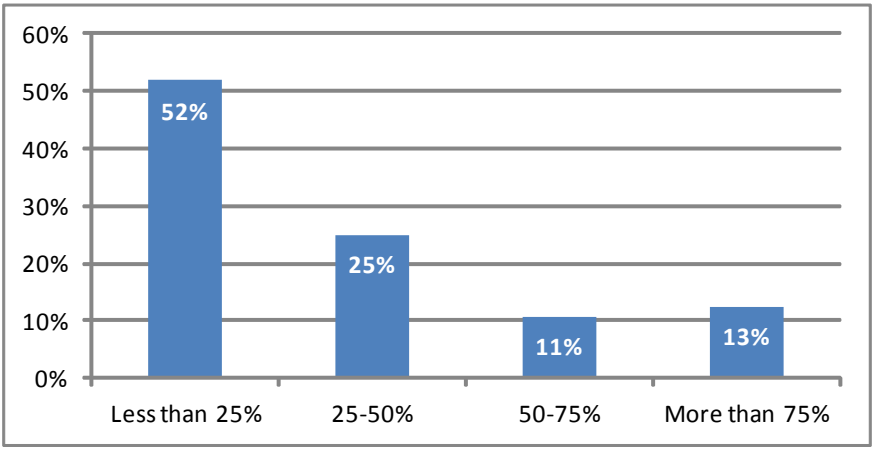
Main purchasers of automotive supplies (% of Firms)



Source: SMMT Survey (March-May 2012).

17.2.3 **The suppliers are fairly diversified.** Only one in seven firms have 75% or more of their business with their main customer and more than 50% of all firms have 25% of less of their sales with the main customer. When firms supply more than 50% of the sales to their main customer this purchaser was often Jaguar Land Rover, Nissan, GKN, SAIC (China) and Honda.

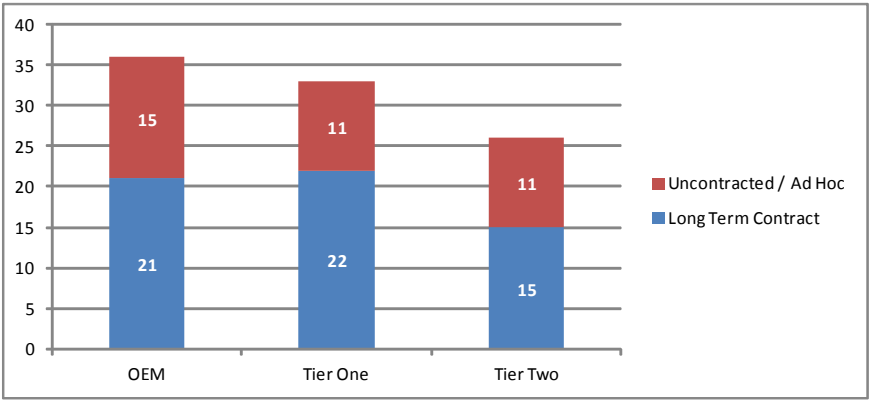
Sales to Main Customer (% of Firms)



Source: SMMT Survey (March-May 2012).

17.2.4 **Tier One, Two and Three relationships.** The survey covered firms which had 35 Tier One supplier relationships with OEMs, 33 Tier Two supplier relationships with Tier Ones and 26 Tier Three supplier relationships with Tier Two firms. More than 60% of these relationships were long term contractual relationships and just under 40% were relationships for ad hoc supplies.

Who do you supply? (number of relationships)



Source: SMMT Survey (March-May 2012).

17.2.5 Firms identified a range of main OEM, Tier One and Tier Two customers for their products and services.

Main Customers (OEMs)	Main Customers (Tier One)	Main Customers (Tier Two)
Bentley	BWI	Aero Engines
Caterpillar	CALSONIC	Freudenberg NOK Mechatronics
Cummins	Calsonic Europe	GKN Driveline
Daimler	Concept Group International	GKN Land Systems
Fiat	Delphi	KAB Seating
Ford	Ficosa	Premier Electronics
Honda	GKN Land Systems	Proseat
Jaguar Land Rover	KUL	
JCB	Lear	
Mitsubishi	Magna	
Morgan	Nissan	
Nissan	Perkins	
Perkins	Radshape	
Unipart	TRW	
	VTL Precision	
	Webasto-Edscha	

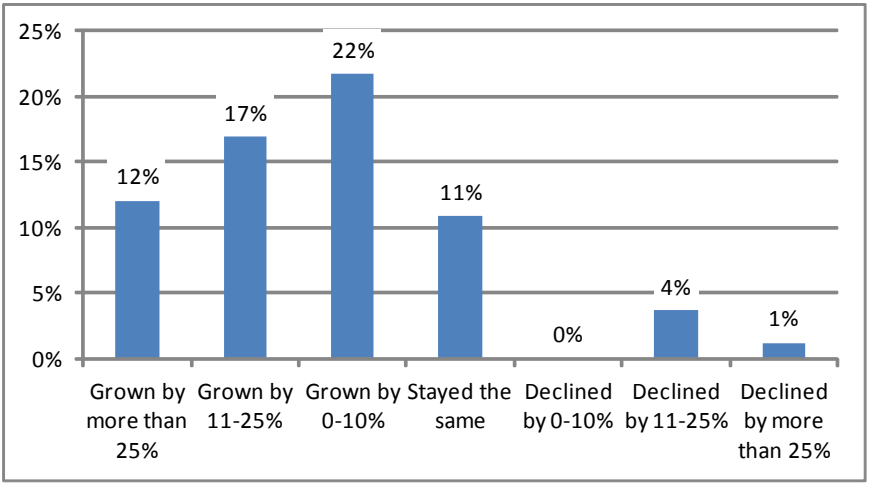
Source: SMMT Survey (March-May 2012).

17.3 **Business objectives and constraints**

17.3.1 **Automotive firms are profitable.** Just under 70% of all firms reported that they were profitable in the last year (including 25% of surveyed firms which did not respond to the question).

17.3.2 **Growing Firms.** More than 50% of firms report that their turnover increased in the last year (and this may be an under-estimate as it excludes 33% of surveyed firms which did not respond to the question).

Turnover – Last Year (% of Firms) Turnover – Last Year (% of Firms)

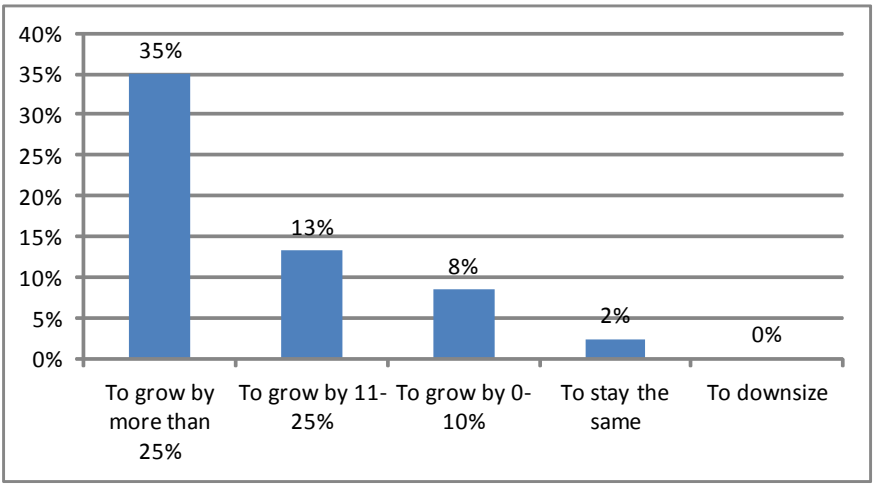


Source: SMMT Survey (March-May 2012).

17.3.3 **Nearly 60% of firms plan to grow in the future, one third rapidly.** Just under 57% of firms report their objectives are to grow their firm in the future (and this may be an under-estimate as it excludes 40% of surveyed firms which did not respond to the question). More than one third of firms aspire to grow by more than 25% in the future.

"We hold aspirations to significantly develop and grow the size of our business in the future. We plan to extend our reach both in the UK and overseas, especially in the developing BRIC economies where we already have some presence."
"To increase automotive by 50% over next 5 years including"
"Diversify the customer base by up to 40% of current sales."
"Increase market share in emerging countries by product diversification"
"Finance needed to enter new markets"
"Growth can be achieved through investment in equipment and training. Also, larger premises will be required."
"The key objective of the company is to develop non-Nissan business to 40% of total whilst at least maintaining current business levels with Nissan"

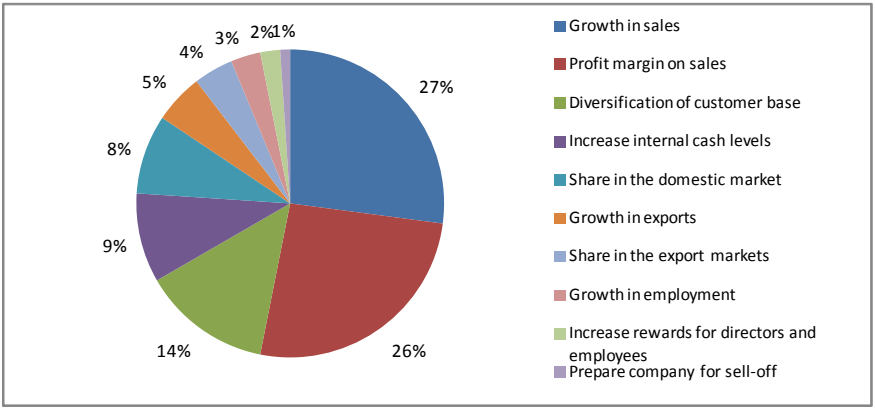
Future Business Objectives (% of Firms)



Source: SMMT Survey (March-May 2012).

17.3.4 **Growing sales, profits margins and diversification are the key business objectives.** Growing sales, achieving an appropriate profit margin on sales and diversifying their customer base were ranked as the most important business objectives by the automotive firms.

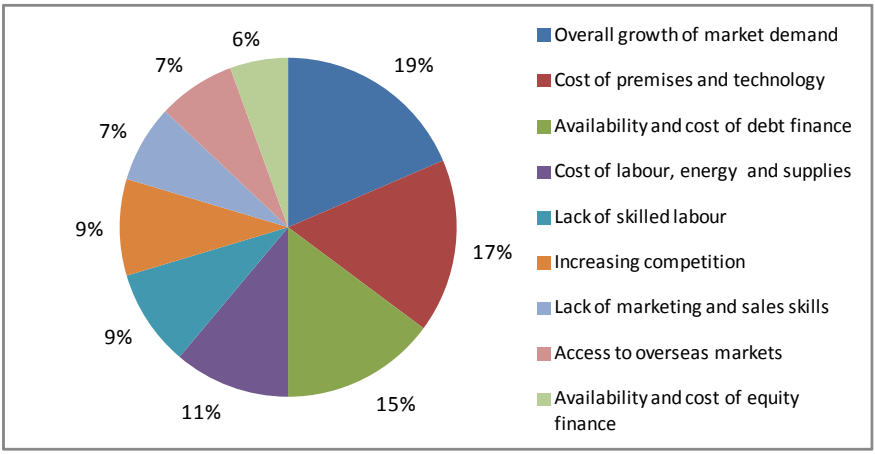
Most Important Business Objective (% of Firms)



Source: SMMT Survey (March-May 2012).

17.3.5 **Growth is being constrained by the scale and rapid increase in the pace of market demand, the costs of premises and technology and debt finance.** Managing the scale and pace of growth in market demand, the costs of premises and new technology and the availability and costs of debt finance, were identified as the most important challenges affecting automotive firms' ability to meet their stated business objectives.

Most Significant Business Challenge (% of Firms)

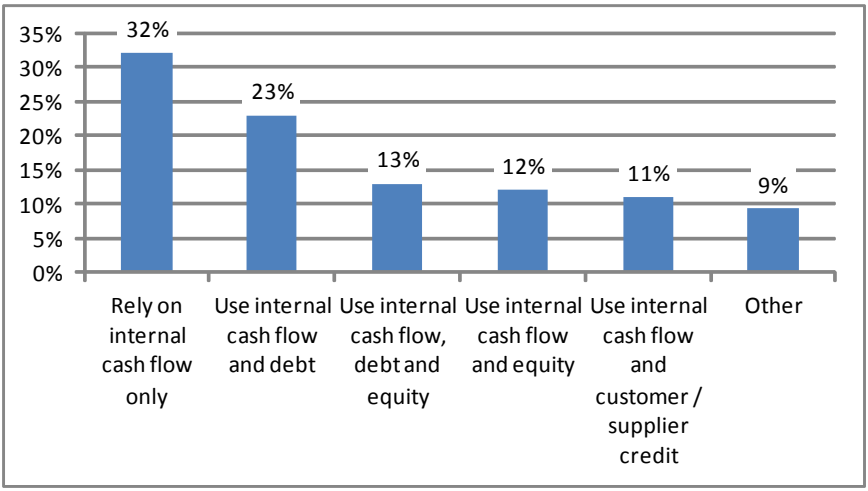


Source: SMMT Survey (March-May 2012).

17.4 **How are automotive businesses financed?**

17.4.1 **Cashflow and debt are the main sources of finance.** More than half of all businesses are using their cash flow alone (32%) or their cash flow plus debt to finance their businesses (23%). Only one quarter of firms use equity finance as part of their financing approach. About 4% of all firms rely on funding from their parent firm.

Approach to Financing Automotive Business (% of Firms)



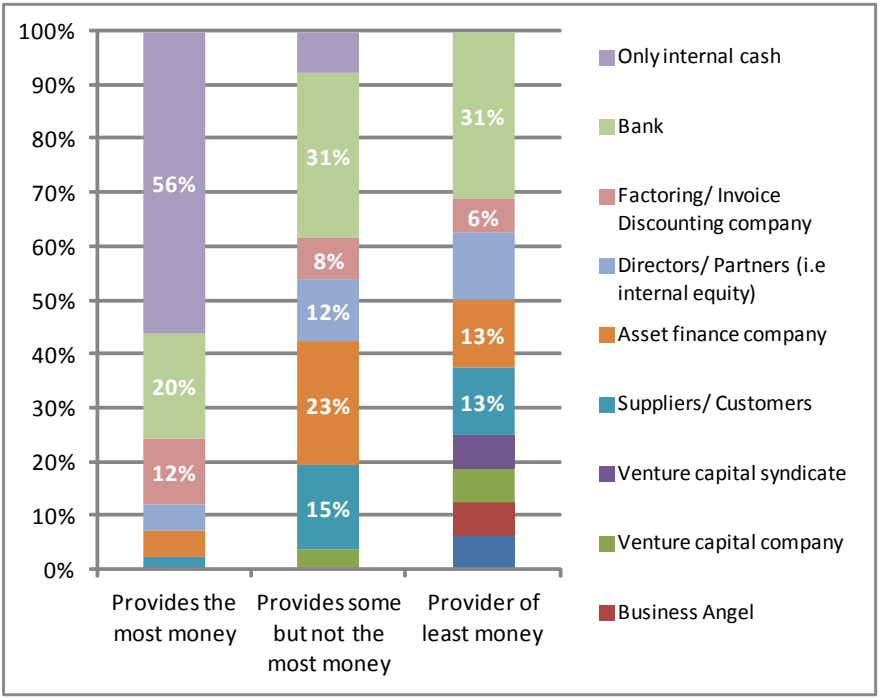
Source: SMMT Survey (March-May 2012).

"There is more focus on financing from internal cash flow than 3 years ago."
"We use FX (foreign exchange) from our parent company as this is cheaper than any alternative in UK or Europe."

17.4.2 **Internal cash is the most important source of finance for the majority of automotive firms.** For the majority of firms (56%) the main source providing the most money was internal cash[39] flow followed by bank loans and overdrafts (20%) and factoring or invoice discounting (12%). Important secondary sources include bank finance (31%), asset finance (23%), finance from suppliers and customers (15%) and equity from directors and partners (12%).

39 BIS's Small Business Survey (2010) found that of those SME employers looking to grow in the next two to three years, that majority (66%) were planning on funding this growth entirely through internal funding sources.

Most Important Sources of Finance (% of Firms)



Source: SMMT Survey (March-May 2012).

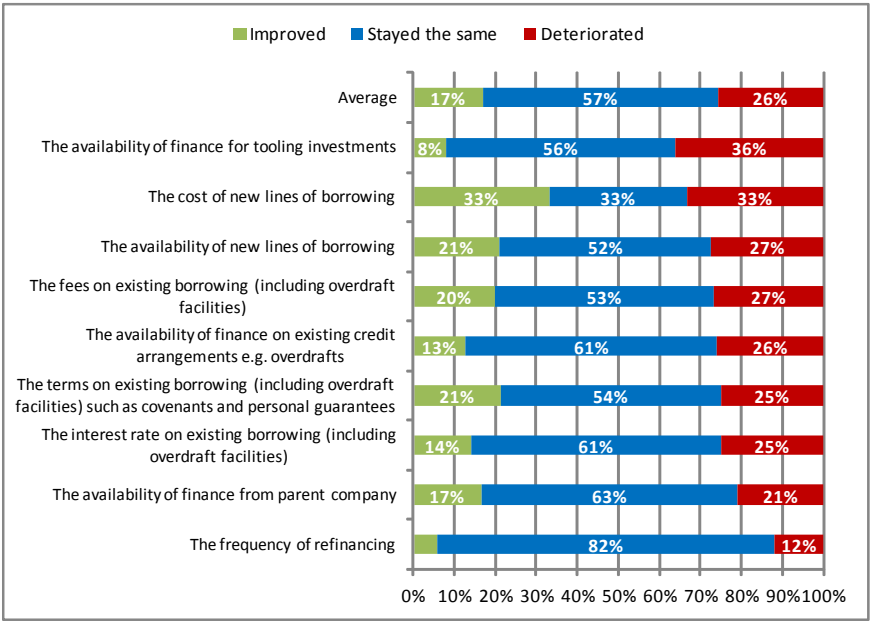
"We recently decided that (as many of our customers were on 90 day terms and suppliers were on 30 or 60 day terms) to move banks and move to Confidential Invoice Discounting (CID)"

17.5 **Changing financial conditions**

17.5.1 **Over the last year credit conditions have worsened for more than one quarter of automotive firms especially in the availability of finance for tooling investments.** On average over the last year finance terms were unchanged for the majority of firms (57%). However, while they had improved for 17% of firms, they deteriorated for 26% of all automotive firms. So for about every two firms reporting an improvement in their financial conditions three report a decline and seven stayed the same.

17.5.2 **The greatest change occurred in the costs of new lines of borrowing** where one third of firms reported that these had improved but one third reported that these had worsened over the last year.[40] More than one third of all firms (36%) reported that the availability of finance for investments in tooling had worsened in the last year (with only 8% reporting an improvement). About 27% of firms reported more expensive fees on existing borrowing including overdrafts[41] and a worsening in the availability of new lines of borrowing. One quarter of firms reported a deterioration in the terms connected to existing borrowing.

Finance: Changing Costs, Terms and Conditions over last year (% of Firms)



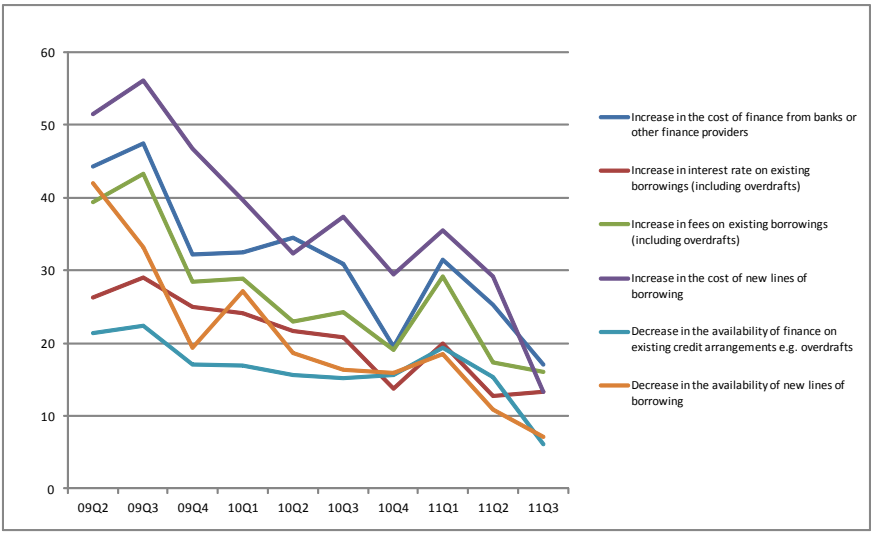
Source: SMMT Survey (March-May 2012).

40 These results are in line with findings for the wider manufacturing sector. In quarterly surveys by the EEF on average 31% of manufacturing firms reported a significant or moderate increase in the costs of finance in each quarter since the end of 200 rising to more than 37% of firms for new lines of borrowing.

41 Capital adequacy rules have tightened including higher capital ratios and new specific rules on risk weightings on SME loans and overdrafts. The impact of these rules is likely to fall disproportionately on smaller businesses which tend to be riskier and have higher risk weightings attached (Breedon Report March 2012)

17.5.3 **Over the last two years more manufacturing firms report worsening terms and costs of finance.** Quarterly surveys of manufacturing firms by EEF show that persistently more firms are reporting that credit is more expensive or less available than the firms reporting an improvement each quarter, though the net balance is improving over time. For every firm reporting an improvement in finance more than three still report a deterioration in Q3 of 2011.

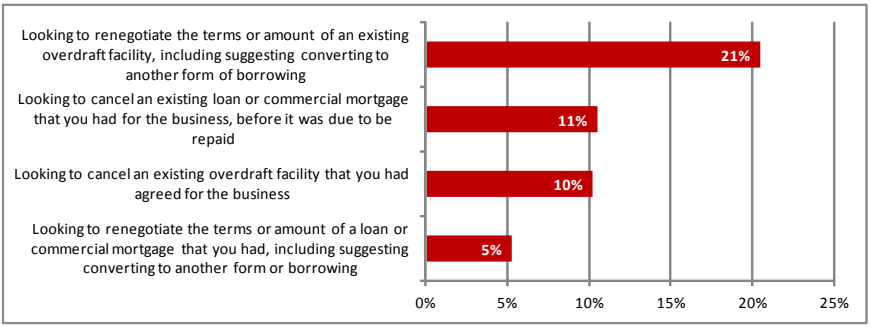
Manufacturing Firms - Deteriorating Costs, Terms and Conditions of Finance 2009-2011 (% firms)



Source: EEF Survey of Members. Financial conditions in two months preceding survey.

17.5.4 **One in five automotive firms was approached in the last year by their bank to alter their finance.** About one in five firms reported that their bank or financial provider had approached them in the last year to renegotiate the terms of an existing overdraft. Banks for about one in ten automotive firms had looked to cancel a loan or commercial mortgage before it was due to be repaid and to cancel an existing overdraft facility.

Bank Behaviour in Last 12 Months (% of Firms)



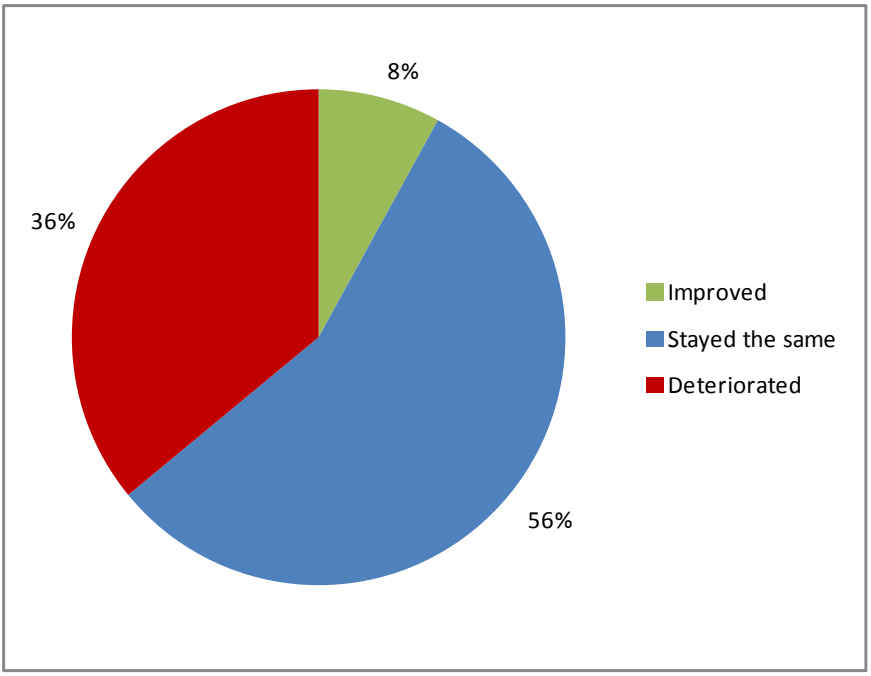
Source: SMMT Survey (March-May 2012).

"Our bank insisted we move from overdraft to Invoice Finance (approximately six years ago)"
"Lloyds bank asked to renegotiate our overdraft facility requesting that the director personally guarantee the whole of the overdraft"
"NatWest removed our overdraft facility without explanation or warning. We survived (just) in spite of the cash flow shock and now bank with Santander"

17.6 Financing tooling costs

17.6.1 **Over the last 12 months finance for tooling has become a particular problem for automotive firms in the UK.** For every firm reporting an improvement in the availability of finance for tooling more than four reported problems in accessing finance to support tooling investments.

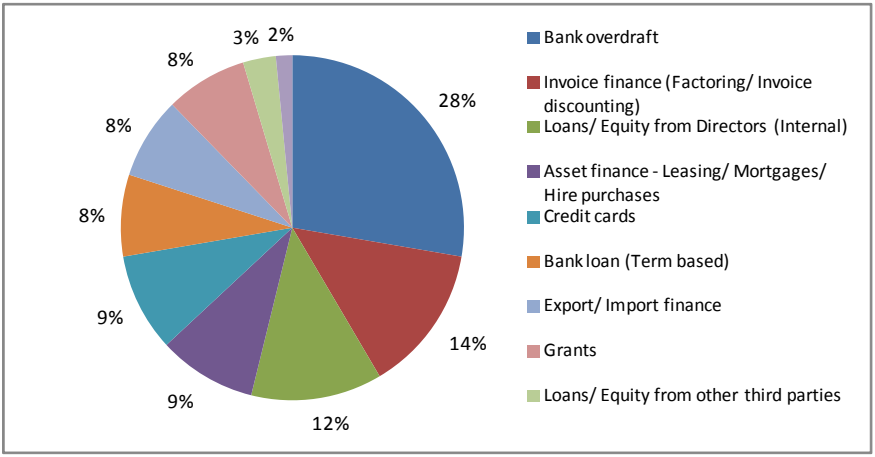
Availability of Finance for Tooling: Change over last 12 months (% of Firms)



Source: SMMT Survey (March-May 2012).

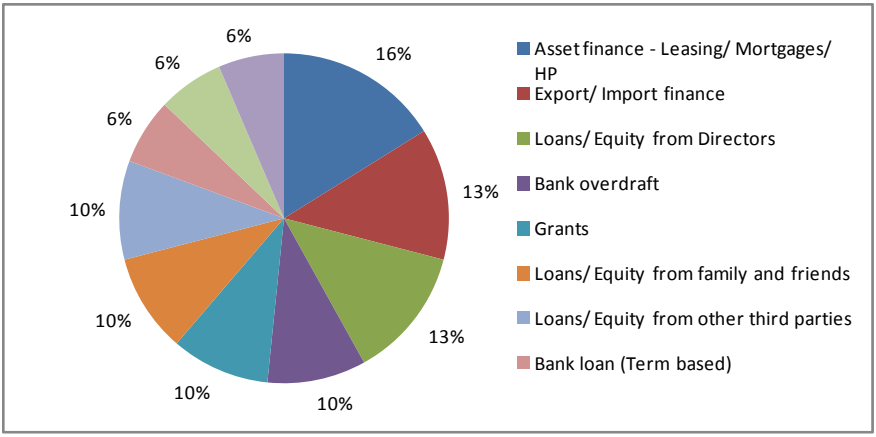
17.6.2 **As a result tooling costs have to be financed from a much wider range of sources.** The main sources of general business finance are overdrafts (28%), invoice finance (14%) and loans or equity from Directors (12%). In contrast tooling costs are being financed by a much wider range of sources including asset finance (16%), export/import finance (13%), loans or equity from Directors (13%), bank overdraft, grants, loans and equity from family, friends and other third parties. Other capital expenditure is being primarily financed by grants, asset finance, bank loans and bank overdrafts.

Sources of General Business Finance (% of Firms)



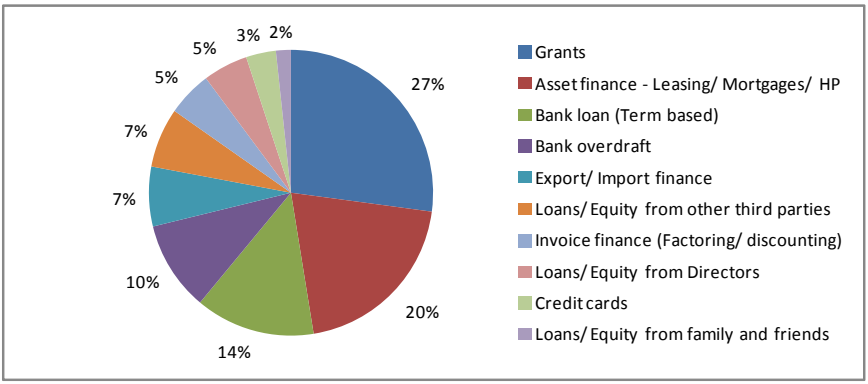
Source: SMMT Survey (March-May 2012).

Sources of Finance for Tooling (% of Firms)



Source: SMMT Survey (March-May 2012).

Sources of Finance for Other Capital Expenditure (% of Firms)



Source: SMMT Survey (March-May 2012).

17.7 Seeking new finance

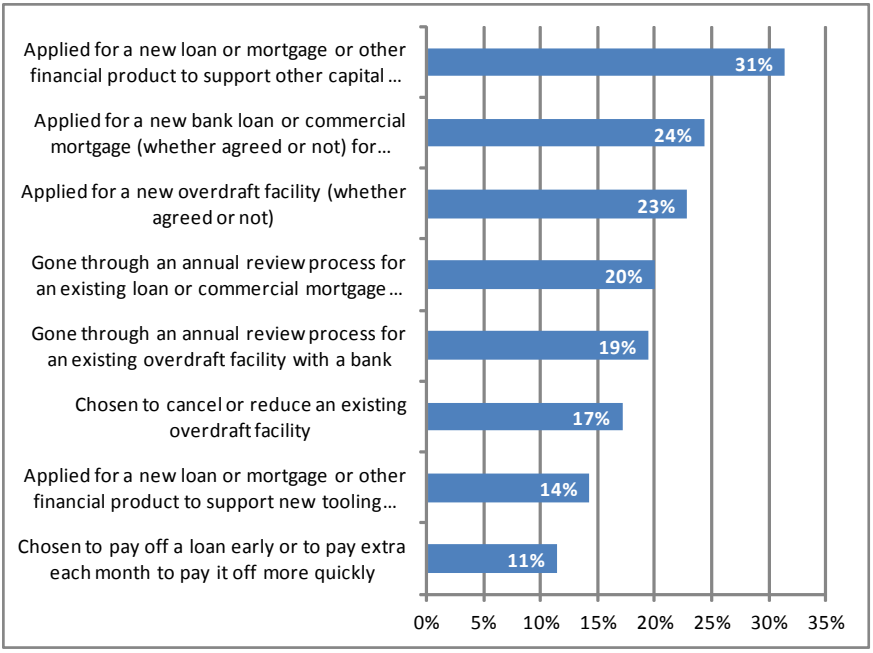
17.7.1 **Half of automotive firms want to raise finance for growth.** More than 45% of firms would like to raise additional funds to grow their business in the future (and this is could be an under-estimate as 27% of surveyed firms which did not respond to the question).

17.7.2 **About one third of automotive firms applied for a new loan or mortgage in the last year for capital investment or general business finance.** More than one third of automotive firms applied for a loan or mortgage in the last year for other capital investment. One quarter of firms applied for a loan or mortgage for general business finance or working capital or applied for a new overdraft facility. One in ten firms paid off a loan early or more quickly.[42]

"We have arranged a loan from our pension scheme and also have financed capital equipment via Lombard".
"The bank discouraged an application to refinance existing loans over a longer period as it was implied the refinancing would not be granted even though the company is profitable. The bank was happy to propose invoice financing as an alternative."

42 The Bank of England has found that net lending has been contracting with firms paying down loans.

Firms Seeking New Finance in Last 12 Months (% of Firms)

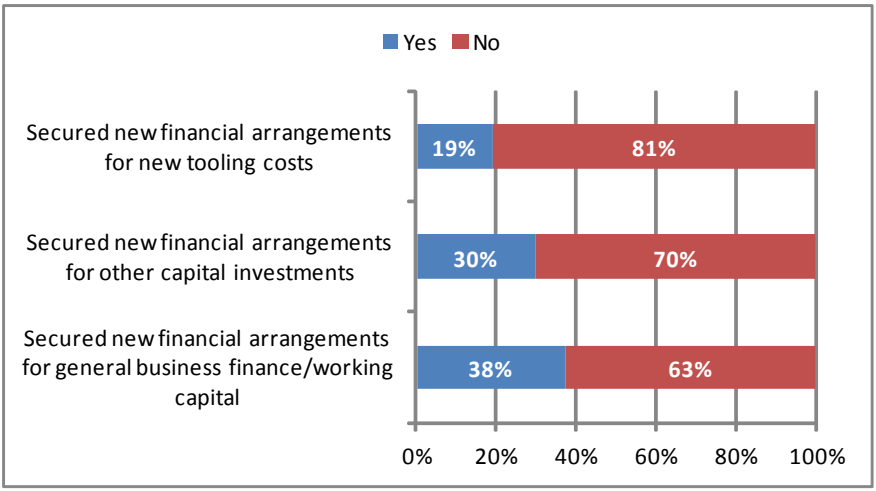


Source: SMMT Survey (March-May 2012).

"We always conduct an annual review with our bank. We have had a new relationship manager every year for the last five years"
"The bank chose to reduce existing overdraft facility due to a reduction in the valuation of our current premises"

17.7.3 **Only one in five firms were successful in securing finance for tooling in the last year.** Just under 40% of automotive firms who applied for finance for general business finance in the last 12 months report that they were successful. However, in contrast only 19% of firms applying for finance for investment in tooling costs were successful.

Success in Seeking New Finance in Last 12 Months (% of Firms)



Source: SMMT Survey (March-May 2012).

17.7.4 **Lack of security is the main barrier to securing funding.** For those firms who were unsuccessful in securing finance the main reason was a lack of security or insufficient security. Other reasons included banks that were not satisfied with financial forecasts, poor personal or business credit histories, applying for too much funding and the need to have more equity in the business.

"Banks are not financing companies for even modest investments (under £100k) and will only lend money (for any amount) with a personal guarantee – no way!"
"We were not prepared to provide personal security in addition to business assets"
"We're down to pre-pack[43] after 37 years of trading"

17.8 **Financial provider performance**

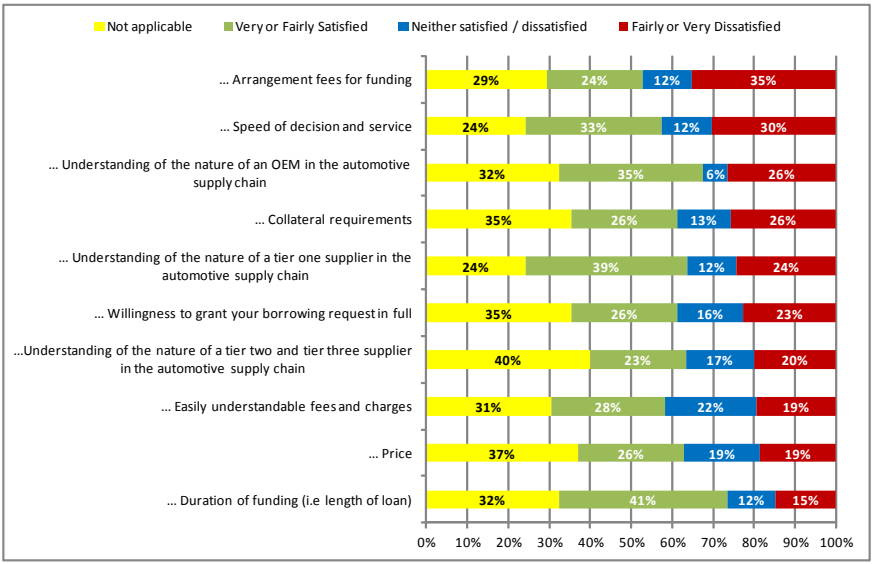
17.8.1 **Automotive firms are polarised in their views of their bank or main financial provider.** On average 30% of firms report that they are very or fairly satisfied with a range of service and price measures while 24% of

43 Pre-packaged insolvency (a "pre-pack") is a bankruptcy procedure, where a restructure plan is agreed in advance to a company declaring its insolvency. Pre-packs have become more popular since the Enterprise Act 2002 which made administration the dominant insolvency procedure.

firms report that they are very of fairly dissatisfied. Only 14% are neutral on the issue and it is not applicable to about one third of firms as they utilise internal cash or funding from their parent to finance their firms. Automotive firms are particularly unhappy about arrangement fees, the speed of decision, levels of service and understanding of the automotive supply chain.

"Lombard have been fine, NatWest were appalling, our own pension scheme is under our control"

Satisfaction with Financial Providers (% of Firms)



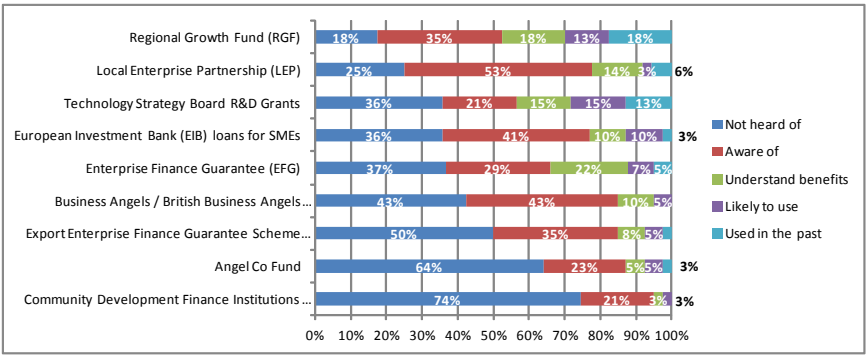
Source: SMMT Survey (March-May 2012).

17.9 Support needs

17.9.1 **Automotive firms have a high awareness of the Regional Growth Fund and their Local Enterprise Partnership.** Nearly one third of firms had or would use the Regional Growth Fund (RGF) with only one in six firms saying they were unaware of the fund. Similarly there was a high awareness of Local Enterprise Partnerships (LEPs) though only 9% of firms had used them or were likely to use them in the future. More than one quarter of firms had or would use Technology Strategy Board

(TSB) R&D Grants. Firms had a much lower awareness of CDFI loans, sources of Business Angel investment[44] and Export Enterprise Finance Guarantee Scheme (EXEFG), which was launched a year ago in April 2011.

Support Initiatives (% of Firms)

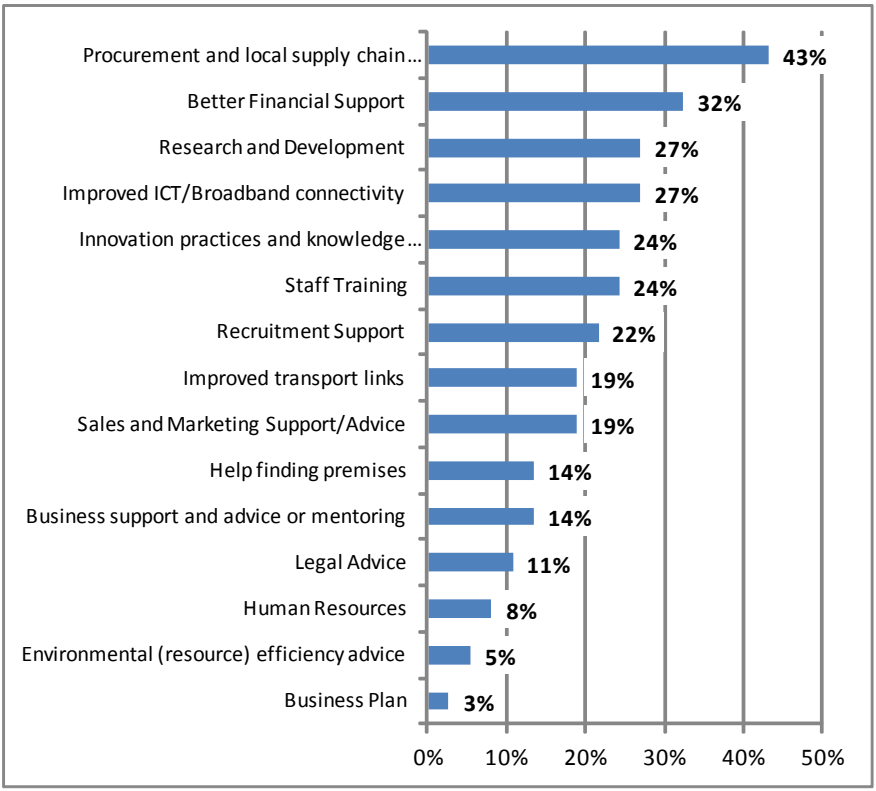


Source: SMMT Survey (March-May 2012).

17.9.2 **Automotive firms want support with procurement, finance, R&D and broadband connectivity to improve their competitiveness.** To improve their competitiveness 43% of firms would like additional help with procurement including the development of local supply chains and about one third of firms would like better financial support. About one quarter of firms would like help with research and development, better broadband, improving their innovation practices and staff training.

44 However one of the first five investments by the Angel Co Fund serves the automotive sector. In total £7.2 million has been invested in the five deals with £1.4 million from the Fund and a further £5.8 million from other investors. Phase Vision, a Loughborough based company producing high accuracy industrial inspection equipment for the aerospace, nuclear and automotive industries, was a recipient. Their innovative 'white light scanners' enable more efficient manufacturing, delivering lower waste, cost and environmental impact.

Support Needs (% of Firms)



Source: SMMT Survey (March-May 2012).

17.9.3 **Job applicant skill gaps.** The main skill gaps that automotive firms reported in the job applicants that they see were, in order of prevalence, technical and practical skills (24% of firms), literacy and numeracy skills (14% of firms), problem solving skills and supervisory skills.

17.9.4 **Workforce skill gaps.** The main skill gaps that automotive firms reported in their current workforce, in order of prevalence, were management and supervisory skills (18% of firms), basic computer skills (13%), foreign and English language skills (10%) and problem solving skills.

"We need support for apprenticeship programmes for key engineering skills training; in particular for maintenance technicians."
"Manufacturing requires 580,000 engineers and technicians over the next five years".[45]
"In common with many companies, we have difficulty recruiting qualified engineers and technicians"
"Recruitment at the moment not a major issue except for the continual increases in the Minimum Wage"
"In general it's becoming more difficult to find skilled people who have completed a relevant apprenticeship"

45 Dick Olver – Chair, BAE Systems (6 March 2012)

Section 18

Case study: commodity supply chain

18 Case study: commodity supply chain

18.1.1 To examine supply chain relationships a series of case studies down the supply chain were completed for an automotive commodity (a driver's seat produced for Nissan).

Case study– commodity supply chain (Nissan Driver's Seat)

- The supply chain for a driver's seat for Nissan is relatively complex with 95 components being sourced from 17 different suppliers in 18 different location in the UK and worldwide. Proximity and guaranteed delivery, often on a daily basis, reflecting Just in Time operations are key attributes of the supply chain.
- The suppliers to Nissan at Tier One and Two are all relatively large international and financially healthy firms with access to capital markets, access to equity funding and sufficient cashflow to finance their own tooling and investment costs. The firms were aware that financing tooling costs does pose problems particularly for smaller firms in the supply chain.
- The Tier One and Tier Two companies also supply other OEMs and major automotive Tier Ones respectively. One Tier Two supplier entered the automotive sector five years ago to exploit its existing capital investment in machinery and leverage its knowledge of tooling.
- After deciding which products it can make and which ones it needs to source in, the Tier One supplier's key criteria for selecting suppliers were quality run rates, risk management, strategic and regional footprint.
- While a Tier Two supplier may be UK based sometimes volume production of components takes place in Asia or Eastern Europe with only specialist manufacturing and distribution occurring in the UK.
- All Nissan's suppliers have had to be able to increase their production output in line with Nissan's continuing growth and programme of new model development.
- The Tier Two suppliers are often not at liberty to select their suppliers, being required to use 'customer (OEM) directed firms'.

18.2 **Case study: original equipment manufacturer - Nissan**

18.2.1 Following the announcements in 2010 and 2011 that the 100% electric Nissan LEAF and the next generation Qashqai would be built on Sunderland, Nissan recently announced that two further new models, a mainstream B segment car and a C-segment hatchback, would also be built on Wearside. In total 625 new jobs are expected to be created by these latest investments,

which will take the number of staff at the plant to 6,225 - a record for Nissan at Sunderland. A further 2,500 jobs are expected to be created in the supply chain, as up to 100,000 Invitations and 80,000 hatchbacks a year roll off the production line, bringing annual production up to more than 550,000 vehicles. The company's £252m investment in these two models is being supported by £17.5m from the government's regional growth fund.

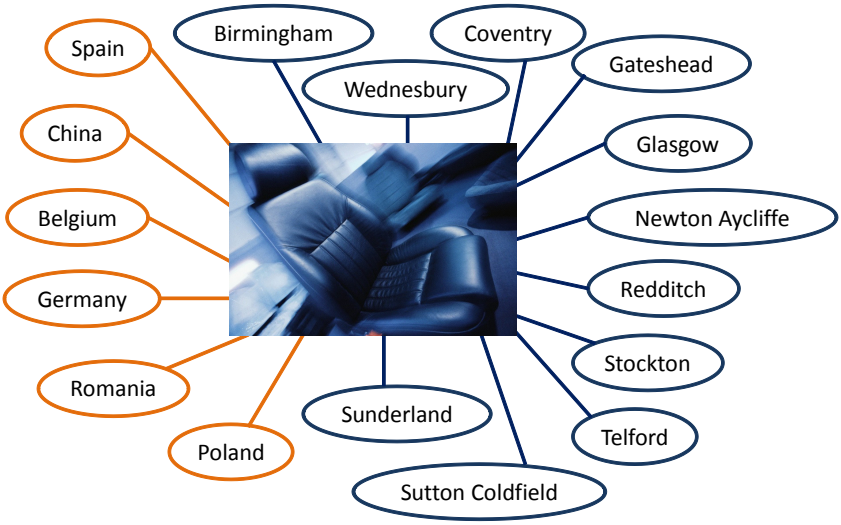
18.2.2 Bouncing back strongly from the 2009 Global Financial Crisis, which led to a loss of 1,200 jobs, Nissan produced 480,485 cars in 2011, 57,000 more than in 2010 which itself was a record for a UK car plant. As well as having successful models like the Qashqai and Juke, the Sunderland plant is one of the most efficient manufacturing plants in Europe with exceptional industrial relations.

18.2.3 Even a single 6-way adjustable driver's seat produced for Nissan has an impressive supply chain all of its own with 95 different parts arriving from 17 suppliers in 18 different locations (11 in the UK and 7 overseas in Belgium, China, Germany, Poland, Romania and Spain). Each part travels an average of 472 km – the shortest is 1 km and the furthest is 9,300 km. Deliveries are daily, weekly and monthly with up to 14 Full Truck Loads a week for some components.

Nissan Driver's Seat: Bringing together 95 different parts

Source: Nissan

1 Driver's Seat = 95 parts from 17 suppliers in 18 locations, travelling from 1km to 93,000km



Source: Nissan

18.3 Case Study: Tier 1– Johnson Controls International

18.3.1 Johnson Controls is a global diversified technology firm with 162,000 staff 150 countries and operating in markets including building energy and batteries and interior systems for cars. With global sales of $40.8 billion Johnson Controls operates as a Tier One supplier providing seating to UK based car manufacturers including Nissan in Sunderland. Based 1 km from the Nissan plant and supplying seating in sequence, Johnson Controls was one of the first Just In Time suppliers to set up in the UK following the opening of the Nissan plant 25 years ago.

18.3.2 Johnson Controls supplies seating to Nissan for the Juke and Note as well as serving other UK-based OEMs. The Sunderland plant of Johnson Controls has seating assembly capabilities as well as metal production.

18.3.3 On the basis of total delivered cost, sourcing for seating production is based across a range of commodities: foam; metal structures (which involve welding); mechanisms (tracks and latches); plastics (shields, finishers, headrest guides); trim covers (cushions and backs , headrests); other small foam parts; and fasteners.

18.3.4 As a global Tier One the initial decision is whether to make components within Johnson Controls or to buy them in from suppliers? From across its business units Johnson Controls sources foam, metals, trim and mechanisms including tracks and recliners. Where Johnson Controls looks to buy in components the key criteria are: quality run rates, price, risk management, strategic footprint and regional footprint (especially if product is heavy).

18.3.5 Metals (including welding), foam and plastics are primarily sourced in the UK. Trim is sourced from Romania. Headrests foams are sourced from Germany. Slides are sourced from Poland. While some of Johnson Controls' suppliers are UK-based some of them source components directly from other countries (e.g. 'Shoot and Ship' custom moulded products from Taiwan).

18.3.6 Any supplier who achieves a Johnson Controls nomination has to be able to meet the demanding timelines of OEMs which have been shortening. Historically development periods could be as long as 48 months but these are often now just 20 months to Start Of Production (SOP) and there are always other milestones to meet in the development cycle. While Nissan's terms are to pay tooling cost at SOP, some other OEMs are later, sometimes after a further 90 days or when additional checks and audits of the parts have been completed and some other ones offer progressive payments. Some suppliers now struggle to meet the timescales and the associated payment schedule especially if they have to pay for 50% to 100% of the tooling costs up front if buying from Leading Cost Countries (LCC). While historically tool costs were spread 1/3:1/3:1/3 even financing tool development costs on this cycle is now challenging for many suppliers, especially down in the supply chain.

18.3.7 A supplier will respond to a RFQ (Request for Quotation) from Nissan and consider whether the opportunity is a viable business in terms of the requirements and terms and conditions. Capital and Development costs will be amortised into the piece price throughout the life of the program that is usually five to six years. With Nissan, tooling cost will be paid at SOP.

18.3.8 Financial institutions in Europe are available to offer supply chain finance for a supplier to be able to drawdown their money at SOP to fund their investment costs.

18.3.9 Spain and Portugal payment terms for firms are being set in law at a maximum of 60 days from January 2013 onwards following a transitional regime started in mid-2010.

18.4 Case Study: Tier Two – TR Fastenings

18.4.1 TR Fastenings is a Tier Two supplier, providing cold forged fasteners and plastic clips to Johnson Controls Inc (JCI) the Tier One supplier of seats to Nissan. As well as being a global preferred supplier to JCI, TR Fastenings also supply Lear and Calsonic, which together dominate the global car seat supply market. TR Fastenings was awarded Lear Corporation's 'Supplier of the Year Award' in 2011. TR supply about 90% of all fastenings in the seats produced by JCI for Nissan and provide components to JCI as a direct line feed (kanban scheduling) on a daily just-in-time basis.

TR Fastenings Kanban System in JCI Plant

18.4.2 As a UK plc and with their HQ in Uckfield in West Sussex, TR has eight distribution centres in the UK as well as sites in Europe and Asia and employs 1,300 staff globally. With seven manufacturing sites globally, most of TR's manufacturing takes place in plants in Malaysia and Taiwan with some specialist production in the UK. TR has a history of undertaking manufacturing operations in Asia as it also supplies the electronics and IT markets which are heavily concentrated in this region. Europe is currently competing well

with Asia, most notably Japan where the strong Yen makes material prices expensive.

18.4.3 Automotive is a fast growing market for TR who have been growing recently, taking on additional staff and operating additional factories. The greatest current challenge is keeping up with the increasing demand from the main car manufacturers such as Nissan, JLR, Honda and Toyota. Nissan provide about one year's notice to allow TR to plan their production and increase the capacity of their operations. Financially the firm is healthy and able to fund their expansion mainly through acquisitions. TR recently spent £15 million purchasing an additional factory in Malaysia funded by bank resources and an equity placement that raised £8 million.

18.4.4 TR generally passes on the term they receive from JCI to their supply chain partners. Tooling costs do not tend to be very expensive - not more than £2,000 - and are generally covered by the customer.

18.5 **Case Study: Tier Two – Supplier A**

18.5.1 With expertise in the manufacture of garden equipment, such as lawn mowers, Supplier A only entered the UK automotive component market five years ago. As a large global firm employing 15,000 people worldwide, Supplier A has annual sales of £2.7 billion and 37 manufacturing plants worldwide.

18.5.2 Historically, the firm has made significant investment in their UK capital equipment – they operate 54 moulding machines (75-1,000 tonne presses) for their own manufacturing operations in the UK which employ 550 people. The firm saw a clear opportunity to leverage this substantial investment and more than 20 years knowledge of tooling (especially in the Far East) to start to supply automotive firms with components. Supplier A has a talented internal pool of staff with tooling expertise from working on their own products.

18.5.3 In five years their turnover has increased from nothing to £10 million andJohnson Controls is now one of four of their major automotive customers. The opportunity to supply JCI came about following a local plastics supplier going into receivership about four years ago. JCI split the tooling to four separate firms and 64 tools were transferred to Supplier A, though it felt that JCI thought they were relatively high risk given their lack of automotive experience.

18.5.4 Their initial orders were shoot and ship plastic components for seats for the Nissan Juke (X12C). In subsequent orders Supplier A supplied JCI in Halewood (L538) with a more added value product. Back panels were moulded by the firm in the UK before being sent to Hungary to be wrapped and brought back to Supplier A for sub-assembly welding. A full back panel was then delivered to JCI. The firm has been able to accommodate the increasing demand from JCI who are supplying seats to Nissan and is now tooling for a new Nissan order for 2013.

18.5.5 Supplier A have a good relationship with JCI and they have been able to work together to understand tooling design issues and jointly develop fixes. As a relatively cash rich organisation Supplier A have been able to absorb tooling costs but feel there is scope for OEMs and Tier Ones to fund more of the tooling costs in advance especially as this will be cheaper in terms of lifecycle costs. As a new entrant to the automotive sector, Supplier A is not always sure that an OEMs terms are passed down the supply chain. They also feel that the practice of charging suppliers for small errors (e.g. £200 for a mislabelled tub) could deter smaller firms from bidding for supply contracts.

18.5.6 In terms of their own suppliers, these are often 'customer (OEM) directed companies', so Supplier A does not have control over its performance in terms of quality, costs and delivery. It would like to be able to be freer to source more of these components locally.

18.5.7 While the firm is recruiting more staff with automotive knowledge, it has struggled to recruit technical staff locally, especially engineering tooling people with specific knowledge of their equipment. However, Supplier A is able to source worldwide from across its operations. Happily, last year Supplier A took on three apprentices as the quality of applicants was so high.

Section 19

Case studies: finance for the automotive supply chain

Case Studies: Finance for the Automotive Supply Chain

19.1 **Types of Finance**

19.1.1 While there are many potential sources of finance for businesses in the UK, the challenge for an automotive supplier is knowing what is available where, what is most relevant and when and how best to access it. Sources of finance include:

- Traditional finance (overdrafts; loans)
    - Banks
    - Government schemes through multiple sources (banks; CDFIs; CFEL)

- Specialist Finance
    - Asset Backed Finance
    - Export Finance
    - Invoice Finance
    - Supplier Finance

- Seed and growth capital
    - Business Angels
    - CDFI specialist finance
    - Venture capital
    - Business Growth Fund
    - Private Equity
    - Mezzanine Finance

19.1.2 **Invoice finance** is a form of short-term funding that releases cash tied up in outstanding invoices providing a supply of capital related to company sales. As an invoice is raised it is sent to the Invoice Finance provider and typically about 70%-85% is paid within 24 hours. The remaining value less a service fee and any interest charges are paid when the invoice is settled in full. The credit rating of the buyer is important. Factoring is the oldest and most common form of invoice finance. The factor is responsible for chasing the debtor for payment. In contrast in invoice financing the firm retains control of their sales ledger and payment collection activities and can be undisclosed to the end customer (confidential invoice discounting).

19.1.3 **Asset finance** supports the acquisition of new assets. Outright purchases

can be a significant drain on working capital and are not always the most efficient way to manage capital expenditure. Asset finance options include hire purchase, operating lease, finance lease and contract hire.

19.1.4 **Supply chain finance** enables buying organisations to make early payments to suppliers. In a supply chain, suppliers finance the period between an order being placed by a customer and the payment being received. Historically, this has often been funded through loans, overdrafts or factoring. However, many of these options have become less readily available or more costly, affecting suppliers' working capital and their ability to fulfil future orders. Supply chain finance uses the buyer company's financial strength to provide lower cost finance to suppliers. The buying organisation notifies the supplier payments provider of invoices that have been approved for payment. The supplier payments provider immediately offers early payment to the supplier ahead of the agreed trade terms. A deduction is made from the invoice value paid to the supplier; however, this is generally less than the traditional forms of supply chain finance.

19.1.5 **Trade Finance** helps firms to mitigate financial risks such as non-payment or delayed payment. Trade finance is a source of working capital, it helps to reduce some of the risks associated with trade and it is linked to the payment. Trade finance mechanisms include bonds and guarantees, letters of credit and trade loans.

19.2 **Case Study: Advanced Manufacturing Supply Chain Initiative (AMSCI)**
Announced in November 2011, AMSCI is a £125 million national initiative to create more competitive supply chains and new employment opportunities. Operated as a competitive process[46] with the Technology Strategy Board (TSB) supporting Birmingham City Council, grants or loans can be offered to successful projects. The focus is advanced manufacturing sectors where the barriers to entry are high and for support with capital investment, R&D and training and skills. The national initiative has developed from a successful Regional Growth Fund bid covering four LEP areas (Black Country, Coventry & Warwickshire, Greater Birmingham and Solihull and Liverpool) which has now been ring-fenced. As a result the fund has been split into two streams running simultaneously which were launched on 29 March 2012 and a project can only apply to one of these:

46 One OEM queried the benefits of having a competitive process for the automotive sector when there were clear and known capacity constraints in their supply chain.

- Stream One offers up to £100 million for collaborative projects from any manufacturing sector in England with a minimum size of £2 million of support per project. Run in two rounds the deadlines for applications for this stream was 13 June and 12 September 2012.
- Stream Two offers up to £25 million for aerospace and automotive supply chain projects based in the four LEP areas with a minimum size of £200,000 of support per project. The deadline for applications was 13 June 2012.

The aim is for a decision from the Independent Investment Board in six weeks by 1 August assuming the main due diligence questions have been covered in the application. Some applicants could start receiving AMSCI funds by September 2012 following appraisal and assessment by TSB, BIS and Birmingham Finance. With about 100 organisations registering for each stream by the end of April there seems to be a good level of initial interest. The aim is to allocate the entire £125 million by autumn 2012 with a possibility for recycling the funds offered as loans in the future. Funding is expected to be offered for a period of up to five years. All participating SMEs are expected to engage with the Manufacturing Advisory Service (MAS) and LEPs are seen as key partners in promoting the initiative.

While AMSCI seems to be better designed to help to address some issues with securing finance for growth and funding tooling development costs there are a number of issues that will affect its ability to address the financial issues affecting the automotive supply chain:

- **The scale of projects.** Even a £200,000 project is a large tooling development for some Tier Two and Three suppliers. A project looking for £2 million of support is aimed mainly at much larger firms. If projects are scored on leverage this further increases the likely project size and reduces its fit with the needs of smaller and medium sized firms. Consortium approaches would be required, which would break up the funding into packages for smaller firms, especially outside the four LEP areas (though the OEMs were sceptical of this approach).

- **Time to market.** It will have taken about a year from the initiative announcement to funds starting to flow, which is still much longer than the three month window that many automotive suppliers have to get in place finance for tooling, and this assumes no major due diligence problems. Extensive negotiations have been required between TSB, BIS and Birmingham City Council to develop the fund.

- **Window of funding.** A rolling fund of applications would fit better with the needs of automotive suppliers who are responding to the demands of car manufacturers and Tier One suppliers rather than public sector cycles.

- **Loans or grants.** It is not clear if there is any preference given to firms requesting grants or loans and the terms applied (clawback, audit, interest rate).

19.3 **Case Study: Advantage Transition Bridge Fund**

Operating until December 2009, Advantage Transition Bridge Fund (ATBF) was funded by Advantage West Midlands and the East Midlands Development Agency. Loans of between £50,000 and £250,000 were considered for SME businesses based in the Midlands which had a viable business plan but were unable to secure finance to progress that plan from normal commercial sources due to restrictions in the conventional credit market.

As a professional run fund terms were flexible and over periods of up to three years. A viable business plan including three years profit, cash and balance sheet projections was required. The interest rate was variable reflecting the nature of the risk undertaken. An arrangement fee and monitoring fees were payable. A charge on the assets of the business, and / or a charge on any assets purchased with the loan, was generally taken. Loans could not be used to repay or reduce existing borrowings. An open dialogue was required with the bankers to the business.

The maturing loan book is now managed by Capital for Enterprise Limited acting on behalf of BIS.

19.4 **Case study: HSBC's Assisted Asset Purchase Scheme (RGF)**

In response the £1 million threshold for RGF applications, in November 2011 BIS announced that RBS, NatWest and HSBC agreed to distribute up to £95 million of RGF to help SMEs invest in new capital assets such as plant and machinery. Under the initiative RGF grants of up to £500,000 will be awarded to SMEs accompanied by bank loans of typically two to five times the size of the grant. HSBC will be lending up to £25 million of RGF as part of its Assisted Asset Purchase Scheme which "enables qualifying businesses to obtain funding towards the acquisition of assets where they would not ordinarily be eligible due to the lack of sufficient stake". Firms need to be

an HSBC customer, be creating additional employment and wish to buy an asset but lack a sufficient deposit. The level of grant provided is based upon the size of the business, the level of asset investment and the number of full time jobs created (1 job must be created for every £25,000 of grant received). Job creation is confirmed by an independent accountant 24 months after drawdown or earlier if borrowing is repaid. The asset purchase is funded by a suitable HSBC Equipment Finance product and the rate of interest can be fixed or variable. A negotiable arrangement fee is chargeable. The firm is able to choose the supplier of the asset and negotiate as if they were a cash buyer.

19.5 Case study: Foxwood Diesel (Lloyds TSB)

Established in 1988, Foxwood Diesel based in Chesterfield supplies Cummins engine parts across the UK as well as diesel engines spares and reconditioned components for bus and truck engines. The company generated a turnover of £800,000 in 2011 and expects this to increase to £925,000 in the future. Having outgrown its old facility, the business has now rented a new 3,000 sq ft unit for the machinery and equipment which are used in manufacturing the components. The old site is being converted into a bus garage. A Lloyds TSB Commercial loan of £117,000 was used to support this growth in April 2012 by expanding its stock and creating two new jobs. With extra space for reconditioned engines Foxwood will be able to complete orders from bus companies in a quicker and more efficient manner.

19.6 **Case study: Spydercars (Lloyds TSB)**

Based in Peterborough, Spydercars specialises in building and restoring classic Lotus cars. With a turnover of £340,000 and employing six people, Spydercars takes orders from car enthusiasts worldwide and restores over 100 cars every year. Using a £140,000 loan from Lloyds TSB Commercial in September 2011 the firm purchased the premises which the company had previously rented since its launch two years ago to give the business a more stable footing. With the premises secured the firms now plans to expand including setting up a paint shop so they can complete the paintwork in-house rather than use subcontractors.

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The author would like to thank all the automotive firms who completed the survey and all those interviewees who generously spared their time and contributed their thoughts for this study:

Mick Aiers (General Motors)
Dave Allen (Jaguar Land Rover)
Chris Black (TR Fastenings)
Rene Chinnery (Lloyds Bank Group)
Stephen Cronin (Yorkshire Bank)
Manual de la Fuente (JCI)
Mark Dodd (Lloyds Group)
Andy Ellis (Nissan)
Jack Glonek (Birmingham City Council)
Paul Heaven (Blue Sky Corporate Finance)
Richard Hill (RBS)
Andrew Johnson (EEF)
Mike Lee (ADS)
Derek Marshall (ADS)
Richard McCulloch (Cabauto)
San Midha (Santander)
Michael Mychajluk (Jaguar Land Rover)
Michael Oxby (Santander)
Stephen Pegge (Lloyds Bank Group)
Ann Pinnington (Hi-Mark)
Steve Potts (Shakespeare Forgings)
Gary Seale (Cobra UK)
Lionel Taylor (Lloyds Bank Group)
Andy Wareing (Nissan)

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