

The Victorian Automotive Components Industry

COMPETITIVENESS, PROFITABILITY AND FUTURE STRATEGIES



March 2005



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The automotive industry, embracing the original equipment manufacturers, and component and other suppliers, is an integral part of the Victorian economy. The industry makes a substantial contribution to state exports, employment, capital investment and gross product, and is an important source of research and development.

While strong volume growth has helped support the profitability of Victorian automotive producers in recent years, nonetheless it is clear the industry is also confronted with a growing number of competitive challenges. Not the least is a worldwide glut of motor vehicle production capacity, which is compelling global vehicle manufacturers to continuously search for new ways to improve efficiency.

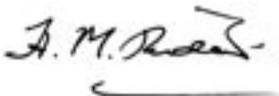
One response has been to develop vehicle platforms common across different regions, which has also allowed the vehicle manufacturers to adopt more globally oriented sourcing strategies. At the same time, however, the strengthening Australian dollar and the rapid emergence of other lower-cost producers (particularly in Asia) are undermining the competitive position of many local component suppliers.

A reputation as an innovative and reliable supplier to local and offshore vehicle producers will not insulate the Victorian component manufacturing industry from these developments. It is increasingly evident the longer term viability of the industry requires individual manufacturers respond with new strategies and new business models.

This study is a first attempt to gauge the extent of these competitive pressures and the strategic responses being pursued by local component suppliers. The project was undertaken by the Australian Industry Group and the Federation of Automotive Products Manufacturers, with the financial support of the Victorian Government and with additional assistance from advisory firm KPMG.

The project was carried out under the direction of Tony Pensabene, Ai Group's National Manager, Economics. Peter Liddell, Director, Business Performance Services and Sharon Smith, National Manager, KPMG Industrial Markets, were responsible for the company interviews and jointly prepared Part One of the final report. Simon Calder, Ai Group Senior Economist, co-ordinated the survey and provided the analysis of the results in Part Two.

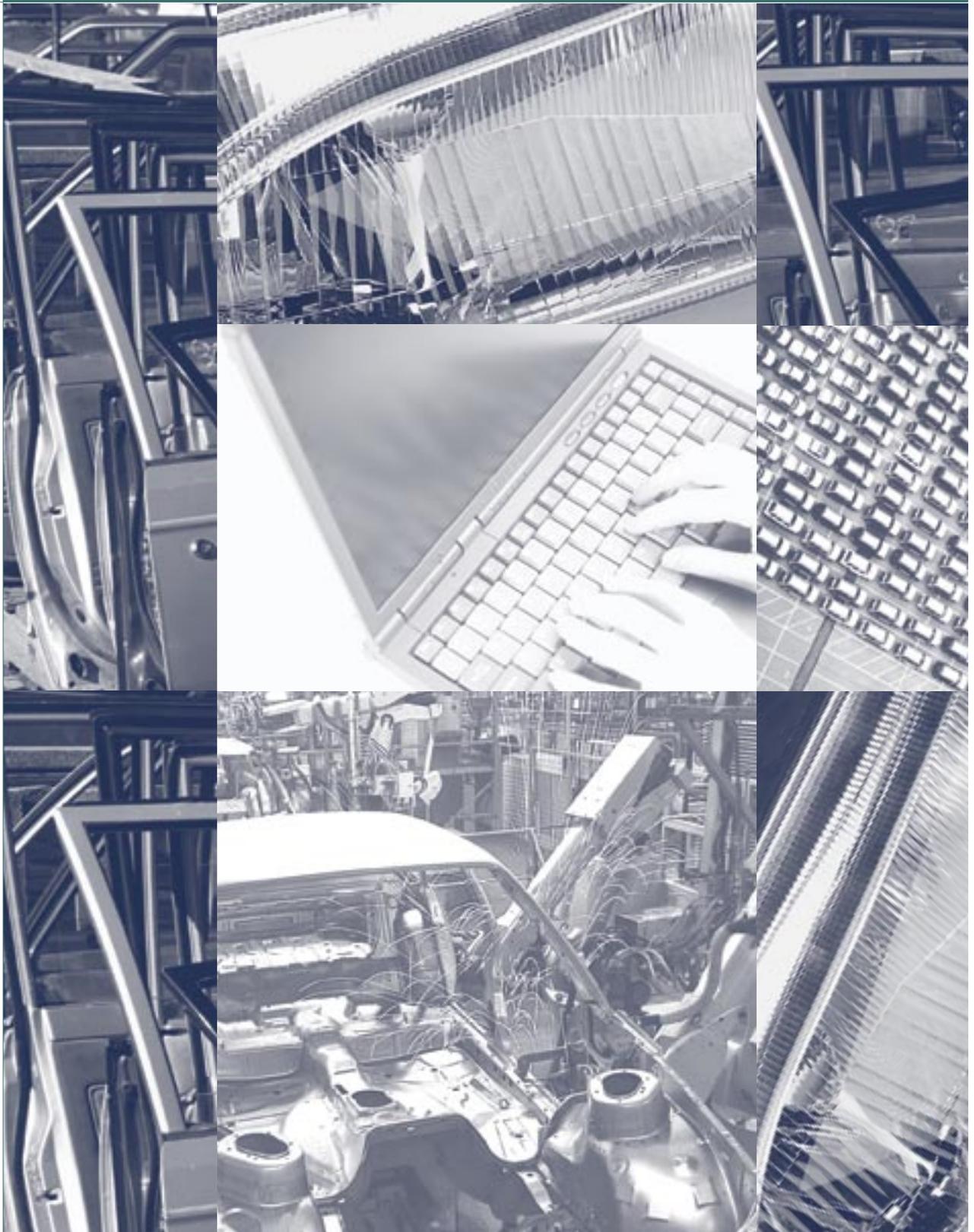
The contributions of the publications and support staff involved in the project should also be acknowledged. However, the sponsors and authors reserve their deepest gratitude for those companies that participated in the study, without whom the project would not have been possible. It is sincerely hoped this report promotes a greater understanding among all stakeholders of the actions needed to ensure the industry retains a pivotal role in Victoria's future economic development.



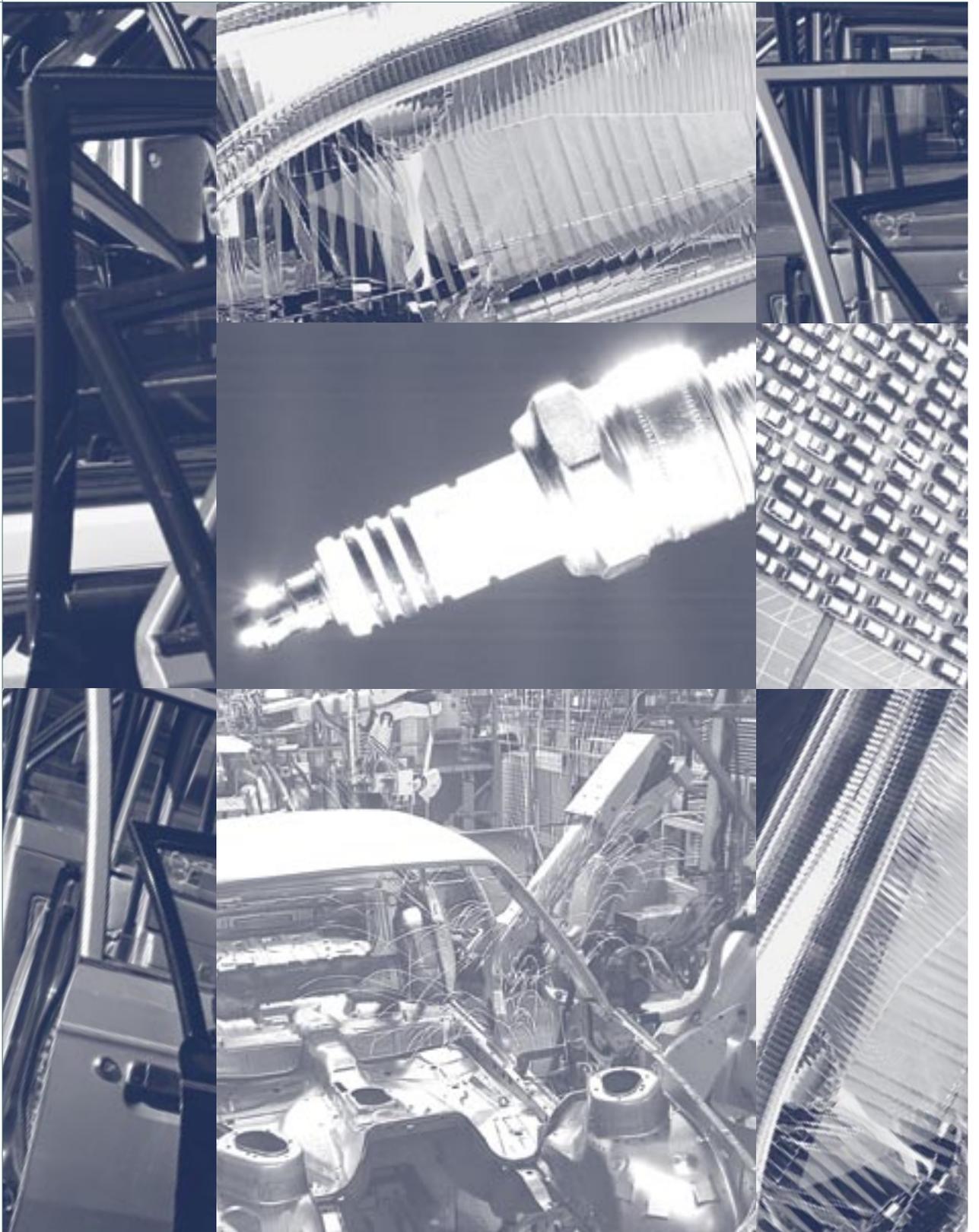
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SECTION	PAGE
PREFACE	3
PART ONE – OVERVIEW AND ANALYSIS	7
1 Executive summary.....	8
2 Introduction	13
3 Key issues relating to the competitiveness of the industry	17
4 Growth in domestic and export markets	20
5 Innovation.....	24
6 Suppliers, customers and competition	25
7 Workplace and skills.....	28
8 Capital investment	30
9 Costs.....	31
10 Manufacturing growth in China.....	34
 PART TWO – DETAILED SURVEY RESULTS	 37
1 Introduction	39
2 Key findings	43
3 Industry profitability	47
4 Company responses – costs productivity and workplace relations.....	52
5 Company responses –innovation, product development and markets.....	59
6 Outlook by sector.....	62
 APPENDIX 1 Survey questionnaire	 65
APPENDIX 2 Case study interview template.....	69



Part One

OVERVIEW AND ANALYSIS

DISCLAIMER – In accordance with the project requirements detailed within the scope document issued by the Australian Industry Group (Ai Group), we have prepared this report to summarise the findings from the case studies undertaken with Victorian automotive component manufacturers. The report provides a summary of the key responses and trends that have arisen during the 30 case studies that were conducted by KPMG along with the responses from the Ai Group survey. It is a collation of the comments received in the case studies and is not the opinion of KPMG's partners or employees.

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1. Executive summary

Victorian automotive component manufacturers are currently facing a number of critical issues impeding their overall competitiveness. The most significant issues include rising labour costs, OEM purchasing practices, rising raw material prices and industrial relations issues.

1.1 Objectives of study

In mid-2004 the Victorian Government, the Australian Industry Group (Ai Group) and the Federation of Automotive Products Manufacturers (FAPM) commissioned a study of the Victorian automotive component manufacturing industry, with the aim of determining the strategies Victorian companies are adopting to respond to competitive pressures. The study comprised a survey by Ai Group of 70 component suppliers, supplemented by 30 interviews of company executives undertaken by KPMG.

The key outcomes required from the study were the identification of the broader challenges and opportunities that confront the Victorian automotive component manufacturers, and the specific strategies they should support to ensure that the local industry remains dynamic and competitive.

1.2 Scope of study

The study seeks to identify the specific actions undertaken by the Victorian automotive component industry participants in response to heightened competitive pressures that they face. It covers the major areas of productivity growth and costs, product and market development, access to factors of production and relationships with other auto-

motive industry producers.

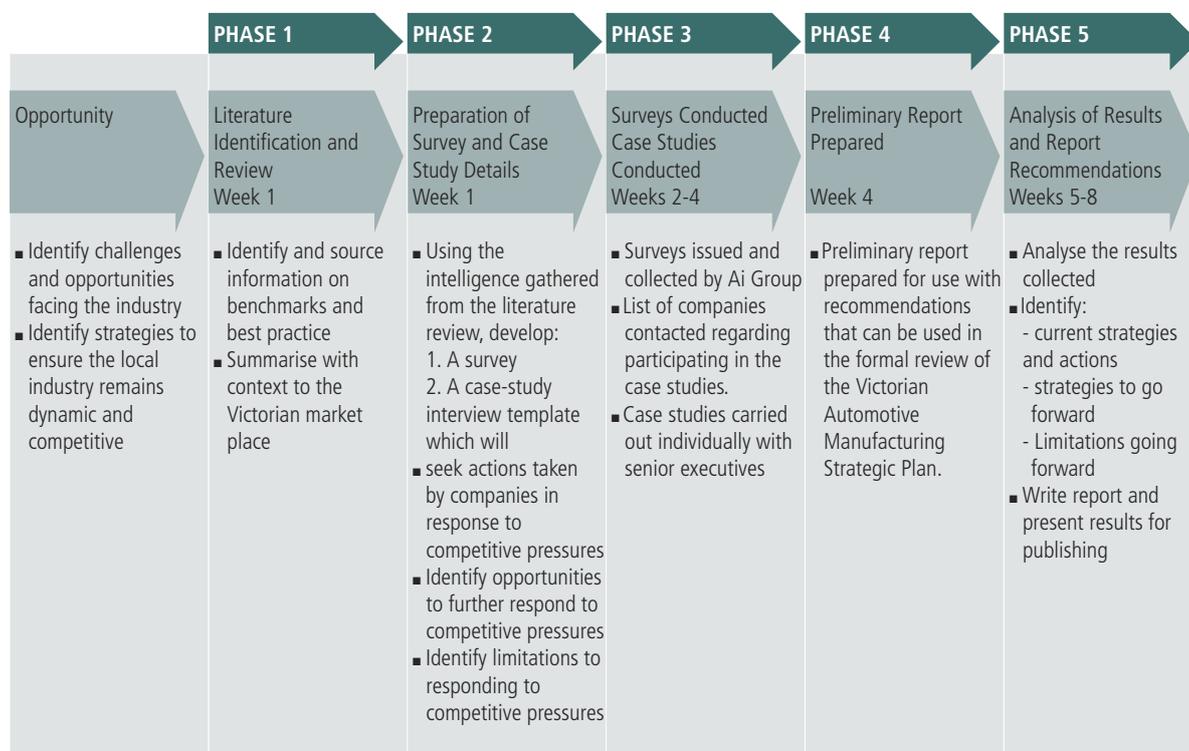
The study focuses on key issues within:

- Market development and export capability;
- Product development, with an emphasis on research, development and innovation;
- Relationships with customers, suppliers and competitors;
- Access to capital;
- Workplace relations and the availability of skilled labour; and
- Cost-downs and other pressures.

1.3 Approach

The first part of this report draws on the findings from both the survey and the case studies. The detailed findings from the survey can be found in Part 2. The diagram on page 9 illustrates the approach that was undertaken by KPMG in order to achieve the specific outcomes defined by the scope document issued in May 2004.





RESEARCH STRATEGY AND ANALYSIS

1.4 Key findings and conclusions

In accordance with the study scope, Ai Group surveyed 70 (primarily tier one) members of FAPM seeking to identify the sources and extent of emerging competitive pressures, and the responses of companies to the changing environment. KPMG also interviewed 30 Victorian automotive component manufacturers in order to gain additional information on the nature of company strategies. The case studies prepared from the interviews encompassed tier one, tier two, tier three and raw materials suppliers, and included privately owned, Australian publicly listed and multi-national organisations.

Both the case studies and the survey identified the local Victorian automotive component manufacturing industry is affected by two main issues impacting the industry on a global scale:

- i) overcapacity; and
- ii) global purchasing strategies.

Globally, overcapacity is a critical issue faced by the industry and has forced cost reduction strategies to be adopted to counteract the high level of market competition. Additionally, the Original Equipment Manufacturers

(OEMs) are trending towards global commonality of platforms, which is enabling them to form global purchasing strategies and compel component manufacturers to become more cost competitive.

1.4.1 Local challenges

The study identified numerous challenges facing Victorian companies in the current environment, including:

- The Australian automotive industry is relatively small by global standards, hampering the ability of its participants to achieve effective economies of scale and impeding their ability to compete in a global market place;
- The rapid emergence of China and other low cost international competitors is compounding global oversupply amongst the major OEMs, forcing the competitiveness of the local manufacturers to become a high priority;
- The rapid appreciation of the Australian dollar has further eroded the competitiveness of Australian manufacturers when competing in local or international markets;

1. Executive summary

- Potential difficulty in sustaining broader domestic demand at the record levels achieved in recent years;
- An industrial relations climate that does not support industry growth;
- Further reduction in federal government assistance from 1 January 2005; and
- Shifting purchasing patterns among major customers, often driven by the global demands of overseas based parent companies

1.4.2 Key issues impeding competitiveness

The majority of case study participants identified the following issues as the most critical factors currently impeding their ability to remain competitive:

- **Labour costs:** Approximately 85% of case study participants believe their local manufacturing processes (comprising a high labour cost component) are uncompetitive when compared to the foreign alternatives, which are manufactured in lower labour cost countries. The survey reported over 90% of the respondents felt both labour costs and emerging low-cost competitors were important factors affecting their profitability in the last twelve months.
- **Global purchasing strategies of OEMs:** Fully 98% of survey respondents reported OEM procurement policies had adversely impacted individual company profitability in 2003/04. Furthermore, over 40% of case study participants believe recent changes to purchasing strategies have severely affected the competitiveness of the Victorian automotive components manufacturing industry. The OEMs are typically comparing the ex-works prices of Victorian components manufacturers to the ex-works prices of offshore components manufacturers often without regard to quality or freight considerations. The survey and case studies indicate a majority of component manufacturers experienced price decreases of between 5% and 8% over the last twelve months as a result of the OEM demands. Despite accepting significant declines in selling prices, moreover, the survey suggests local suppliers may still have lost contracts with a net annual value of \$A250 million - \$A300 million. Local input into forthcoming new passenger vehicle models could thus be expected to decline by up to 5%.
- **Industrial relations:** Over 37% of case study participants believe that annual wage rises in Victoria, which have been continuously maintained at a rate

of 5% for the majority of the last decade, and uncompetitive work practices, are major factors impacting competitiveness. Trade unions are evidently seeking to maintain this rate into the future even though it is above Australian CPI levels and average national pay rates. At the same time, the survey revealed more than half of respondents believed workplace reforms had failed to deliver improved flexibility in the past year.

1.4.3 Key strategies employed by local manufacturers

The key strategies employed by Victorian automotive component manufacturers, in order to mitigate the impact of the issues impeding their overall competitiveness, include:

- **Innovation:** Almost all companies interviewed during the case study program highlighted the research and development (R&D) process is a key strategy to maintain competitiveness in the current environment, as well as providing opportunities to grow into future markets.

Despite innovation and product development being identified as a key growth strategy, the survey found that R&D spend will remain relatively unchanged over the next two years after adjusting for inflation. The modest overall outcome most likely reflects declining demands from the OEMs as local suppliers lose market share to offshore competitors. Australian publicly listed companies and private companies are reliant on internal R&D for this innovation, whereas the multi-national organisations utilise their parent company's R&D and then add value by working with the local OEMs to tailor the technology toward the Australian market. The survey found that the local private companies have the largest R&D spending plans, followed by public companies, with a significantly lower level from the multi-national organisations.

- **Growth to support local economies of scale:** The majority of respondents to the case study process and the survey are implementing strategies that will enable their business to grow. Many Victorian automotive components manufacturers have already lost significant business volumes in their local markets and are primarily looking at other sources of domestic growth to restore previous economies of scale (including supplying those OEMs with which they have no existing relationship and in some instances diversifying into completely different industries). Export markets are considered to be too difficult for them to effectively compete.

The case studies and survey also highlight that many Victorian automotive component manufacturers have designed specific initiatives and programmes to support this growth strategy and maintain their competitiveness into the future, including:

- Creating technological advantage over their competitors by designing for local markets;
- Exporting intellectual property as a key part of their future survival strategy;
- Offering their products to OEMs who are not existing customers, and that they are preparing in advance for the next round of model tender invitations;
- Providing capital investment for new equipment or modifications, which aims to lead to capacity or productivity gains;
- Planning to diversify their product ranges in order to supply new customers within and outside of the industry;
- Enhancing production processes, by incorporating the use of tools such as Lean Manufacturing and Six Sigma;
- Outsource some or all of their production processes to lower-cost countries ensuring use of their own designs; and
- Many tier one organisations are considering importing components (commodities) and adding value to them locally and/or importing sub-assemblies.

The survey results reported approximately 40% of all Victorian automotive component manufacturers expect to have outsourced some or all of their production processes to lower-cost countries by 2006, with the breakdown of 63.6% of Australian public companies are planning to outsource, followed by 42.3% of multinational organisations, and 30.3% of private companies.

The survey results also showed 80% of manufacturers will switch to lower cost suppliers of basic or semi-processed inputs by 2006, many of whom will be offshore. This was supported by the case study results where 87% of participants who are not already importers, are currently evaluating or considering the option of sourcing components, both semi-finished and finished, from offshore.

1.4.4 Government assistance

Many of the component manufacturers interviewed had already started adopting new strategies to help maintain their businesses at competitive levels into the future. However, many have realised they require a greater level of support from the government to keep their business viable in the longer term. The specific types of government assistance highlighted include:

- The continuation of ACIS (Automotive Competitiveness Investment Scheme);
- Assistance with establishing export markets;
- Research and development assistance; and
- Any cost saving initiatives that can be engaged within the work place, particularly employment costs.

Free Trade Agreements (FTAs) were considered neutral with countries at a similar stage of economic development as Australia. However, most Victorian automotive component manufacturers considered them a threat with countries with overcapacity of product types, or lower wage structures to Australia.

1.4.5 Major advantages to be exploited by the local industry

The case studies highlighted a number of key areas where Victorian automotive components manufacturers have created competitive advantages over imports, including:

- **Local engineering:** Most case study participants believe the competitive advantage derived by the local Victorian manufacturers is due to their engineers being located in close proximity to the local environment and nearer to the OEMs. These engineers are therefore able to work intimately with the OEMs to develop and design the products to suit the local platform.

Local product development is considered to be extremely advantageous, as frequent changes occur and flexibility is needed to support the process.

Australian development also tends to be significantly cheaper than the development costs incurred by the European or American counterparts. Hence, the OEMs are supportive of local design.

- **Logistics capability:** The majority of case study participants claimed their local logistics capability gave

1. Executive summary

them a significant advantage over imported products. The competition from offshore is typically unable to change the delivered product at short notice, is unable to deliver just in time, and does not allow the OEMs to keep their inventory levels to a minimum.

- **Model mix complexity within the Australian industry:** The complexity of the model mix within the Australian automotive industry is significant and is designed to meet local consumer trends. The number of variations to each model platform is high, particularly with such a small market size.

This unique complexity is advantageous for the Australian component manufacturers as it makes it difficult for imports to match the complexity of the model mix. As the OEMs do not know exactly which variations they are going to sell, it is difficult for them to pre-order large amounts of import materials.

1.4.6 Major disadvantages to be mitigated by the local industry

- **Eroding the industry (ie omitting tier two, tier three and raw materials suppliers etc from the supply chain):** With many future growth strategies involving sourcing lower cost material imports, there is likely to be an erosion of the lower tiers in the industry. The Victorian automotive component manufacturers are expecting to be able to take a significant amount of cost out of their process by importing part components and sub-assemblies, and having only the final stage of production completed locally. As a consequence, the local manufacturers of these components may no longer have a local customer base.
- **Lack of economies of scale:** The volume of the Australian market is not sufficiently large to economically absorb the cost of overheads and design. Given that offshore competitors are working from a larger volume basis, the loss of one or more OEMs within Australia will severely impact the ability of the Victorian automotive component manufacturers to maintain their economies of scale.
- **High and inflexible labour costs:** Local labour costs are an extremely high proportion of the product cost for Victorian automotive component manufacturers, whereas it is a much smaller percentage of the total cost for offshore producers. Further pressures are compounded by ongoing increases as part of the regular EBA process.

1.4.7 Future outlook

Overall, the study found the industry is reasonably positive about its prospects over the next two years. Publicly-owned Australian companies remain especially optimistic, reflecting a combination of relatively more success in securing future supply contracts and aggressive strategies to cut costs (the latter including a narrower product focus and the use of global supply networks to switch to lower cost inputs). While privately-owned Australian companies and the local affiliates of multi-national companies both anticipate a modest deterioration in profitability over the next two years, their strategic responses are quite divergent. Locally owned companies expect to enhance competitiveness through R&D and a wider product range, while the internationally-owned companies appear more likely to scale back domestic manufacturing capabilities and to focus on importing.

Further out, several executives have concerns on the sustainability of the local industry. With the global purchasing strategies of OEMs changing, and the continuing development of manufacturing in low labour cost countries, executives consider the level of competition for the next models (to be developed in approximately five years time) may severely reduce the number of locally manufactured components appearing in the new vehicles.

Beyond the five-year timeframe, many local executives question whether the current number of domestically built models can be sustained, and also the extent to which they are likely to include locally supplied components.

The Victorian automotive components manufacturing industry has shown resilience to date, and has been a strong developer of technology for the local market. The future is uncertain for the national industry at this point in time, however, the industry appears to be making a concerted effort to have strategies in place, and make recommendations for support, to combat the challenges it is facing.

To respond to the change the Victorian automotive industry has seen in the last two years, this study aims to ascertain the strategies that local companies are implementing as a result of the challenges. It is anticipated the outcomes will assist the Victorian government to define further actions that could support the viability of the industry.

2.1 Background

The Victorian automotive industry is the state's largest manufacturing industry, employing more than 30,000 people. The components manufacturing sector is a significant part of the automotive industry and includes:

- Multinational organisations;
- Australian listed companies;
- Private Australian companies;
- Automotive parts manufacturers;
- Plastic moulders;
- Electronics manufacturers and assemblers; and
- Iron and steel manufacturers.

The Victorian Government's Automotive Manufacturing Industry Strategic Plan, published in December 2001⁽¹⁾, defined one of the government's key objectives "In pursuit of automotive manufacturing excellence" (page 4). As the government undertakes a subsequent review of this strategic plan in 2004, it has realised that many significant changes have been experienced by the industry since the initial investigation.

There are challenges experienced by the automotive industry on a global, national and local scale. Globally, overcapacity is the major issue faced by the industry and is leading to cost reduction as a necessity amongst the manufacturers due to significant market competition. Additionally, the OEMs also are trending towards global commonality of platforms, which is enabling them to form global purchasing strategies and forcing component manufacturers to become more competitive.

There are many challenges facing the Australian automotive industry in the current environment, including:

- The Australian automotive industry is relatively small by global standards, hampering the ability of its participants to achieve effective economies of scale, which allows them to compete in a global market place;
- The rapid emergence of China and other low cost competitors is compounding global oversupply amongst the major producers, forcing the competitiveness of the local manufacturers to become a high priority;
- The rapid appreciation of the Australian dollar has further eroded the competitiveness of Australian manufacturers when competing in local and international markets;
- Changing tastes and preferences amongst consumers, specifically away from mid-sized family sedans in which Australian manufacturers specialise;
- Potential difficulty in sustaining broader domestic demand at the levels achieved in recent years;
- Further reduction in federal government assistance from 1 January 2005; and
- Shifting purchasing patterns among major customers, often driven by the global demands of foreign parent companies.

Given these challenges and predictions of rapid growth in lower cost manufacturing regions, many Victorian automotive component manufacturers have and will need to constantly define strategies to maintain their competitiveness and ensure the sustainability of the local industry.

(1) "Automotive Manufacturing Industry 2001 to 2011. Strategic Plan". Government of Victoria. Melbourne. 2001

2. Introduction

2.2 Objectives

The objectives of this study are to:

- Collect and analyse information from multiple sources regarding the competitive pressures being experienced within the automotive component manufacturing industry in Victoria;
- Identify and review specific actions being undertaken by Victorian automotive component manufacturers, as they affect productivity and costs, product and market development; and
- Use the information collected to recommend appropriate strategies that can be used by Victorian automotive component manufacturers going forward, to ensure that the local industry remains dynamic and competitive.

The study will complement the other Victorian Government initiatives that were commissioned in order to monitor the strength of the local automotive manufacturing industry, including:

- The formal review of the Victorian Automotive Industry 2001-2011 Strategic Plan, due in June 2005;
- A support project being developed by Industrial Relations Victoria, the purpose of which is to build industrial relations capabilities amongst participants in the automotive components industry, with the aim of reducing industrial disputation and improving supply chain reliability; and
- Additional research into the means of broadening and deepening Victoria's elaborately transformed manufactured (ETM) export base (including automotive manufacturers), as recommended recently by the Manufacturing Industry Consultative Committee (MICC).

2.3 Scope

The study has focused on the Victorian automotive component manufacturers and seeks to identify specific actions that have been undertaken in response to heightened competitive pressures. The study incorporates an assessment of the major areas that include productivity growth and costs; product and market development; access to factors of production; and relationships with other automotive industry producers. These major areas are outlined under the following key headings:

- **Market development and export capability.** External orientation is a crucial factor in overcoming the absence of domestic scale economies. Areas covered include the potential benefits of recent bi-lateral trade agreements. The study also considers the extent to which local manufacturers are constrained by the global production strategies of overseas-based parent companies.
- **Product development, with an emphasis on research, development and innovation.** It is recognised that these are critical factors in sustaining competitiveness and volume growth. Areas probed include the sources of innovation, whether by in-house research and development, spillovers from other industries or publicly-funded institutions or by transfer from overseas affiliates.
- **Relationships with customers, suppliers and competitors.** The study seeks to determine the scope for improved management of supply chains. It also identifies synergies and scope for strategic alliances and partnerships (with both domestic or international partners). The study also includes instances where industry rationalisation may be the appropriate strategy.
- **Access to capital.** This is an issue amongst smaller private companies. Adequate capital is needed to fund investment in information technologies, as well as for retooling and new plant and equipment. Aspects covered include security, cost of funds and the development of banking sector research into the automotive component manufacturing industry.
- **Workplace relations and the availability of skilled labour.** The key focus is on the innovative practices or provisions in enterprise agreements that have improved productivity and reduced costs. The study identifies those measures that have promoted a more co-operative workplace culture between management, employees and trade unions (where relevant). It also discusses any key emerging skills shortages.
- **Cost-downs and other measures.** There is anecdotal evidence that some component producers may be prepared to accept a lower return on capital. The study seeks to identify the extent and implications of such behaviour. The study also reveals the specific measures employed at the firm level – other than workplace reforms – to enhance productivity growth and reduce costs.

The discussion and analysis of the areas outlined above include:

- Results of a survey conducted by the Ai Group, covering the major Victorian automotive component manufacturers; and
- Case studies from 30 consultations, by KPMG, with senior executives representing the key players within the Victorian automotive component industry.

2.4 Literature review

A literature review was undertaken to explore publicly available information including annual reports, press releases, press articles, submissions to the Productivity Commission, and other relevant documents. The information reviewed during this process confirmed the challenges the industry is facing, as detailed by the Ai Group, as well as providing further background of the changes happening in the industry.

The information prepared during the literature review is summarised in the Introduction section of this report. All sources reviewed have forecast continuing capacity growth for the global automotive manufacturing industry, particularly in the Asian region. There was no publicly available information in regard to global benchmarking of component manufacturers. However, press releases and internet searches confirmed that the industry has strategies similar to the Australian marketplace in order to achieve for growth including:

- Rationalisation and consolidation of the industry;
- Product development and expansion;
- Process improvement to drive greater productivity; and
- Shifting manufacturing to lower cost countries, for example Eastern Europe.



3. Key issues relating to the competitiveness of the industry

Nearly all study respondents highlighted that their total labour costs are the single most important element that impacts their ability to remain competitive and compete effectively with low-cost foreign alternatives.

The following three key issues were identified by the majority of case study participants as the most critical factors currently impeding their ability to remain competitive within the current environment:

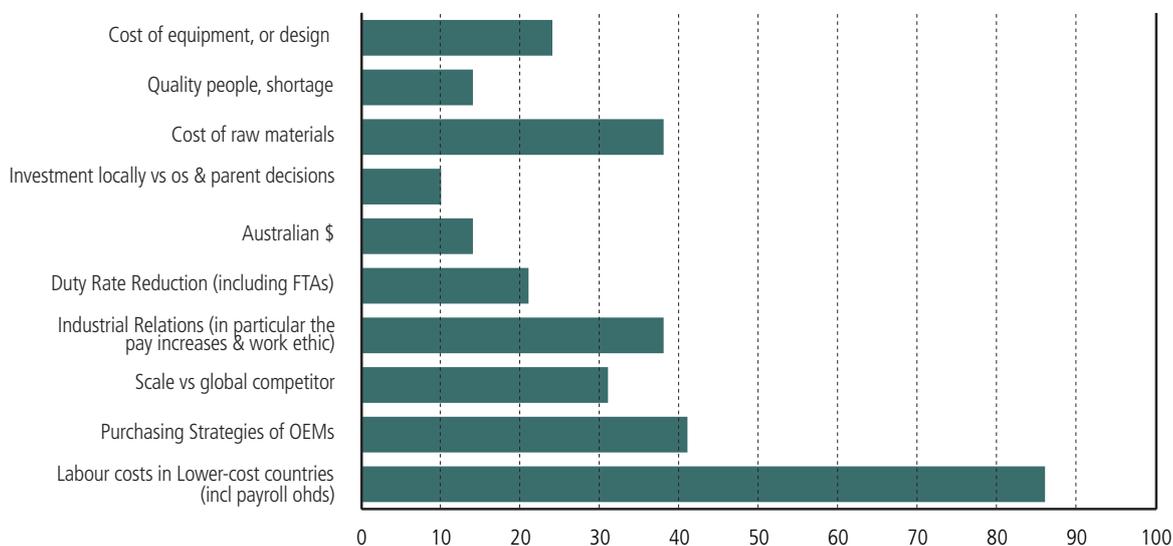
3.1 Key issues – labour costs

The majority of case study participants indicated that their labour costs were uncompetitive when compared to the labour costs in lower cost countries (Chart 1). Local labour costs include workforce salaries and all of the overheads that are associated with the Australian workforce including:

- Payroll tax
- Salary;
- WorkCover expenses;
- Long service leave
- The thirty eight hour week; and
- Rostered days off.

Any manufacturing process with a high labour component was claimed to be uncompetitive in Australia when compared to the manufacturing process of any low cost country.

Chart 1 : Case study participants' responses on the issues that most affect their company's competitiveness.



3. Key issues relating to the competitiveness of the industry

3.2 Key issues – global purchasing strategies of OEMs

The recent changes to the purchasing strategies employed by the OEMs have had a severe impact on the competitiveness of the Victorian automotive components manufacturing industry. The case studies highlight that 40% of participating companies listed this issue to be one of the key factors currently impeding their competitiveness, and of these companies 50% were tier two or lower. The issue appears to be consistent regardless of company ownership structure, with public, private and multinationals having this same response rate to this issue. The case study finding is strengthened by the survey result where 98% of respondents reported that OEM procurement policies have had an adverse impact on their profitability.

The continuous costdown demands on the Victorian automotive component manufacturers are compounded by additional OEM practices, for example where the OEMs now compare the ex-works (i.e. the manufactured price excluding delivery) prices of the Victorian components manufacturers to the ex-works prices of offshore components manufacturers.

The Victorian automotive components manufacturers have been informed that their ex-works price must match the ex-works price of other destinations. In general the local OEMs are not considering the freight costs to import the material into Australia, as they plan to utilise their own global logistics networks to ship the material at competitive rates. This is a major issue for the Victorian automotive component manufacturers, as they must match the product prices of other low-cost manufacturing destinations. The quality and features of the product may be superior in Australia, but the offshore, low-cost price benchmarking still occurs and the OEMs are less inclined to pay premiums for local service.

3.3 Key issues – industrial relations

The third issue that respondents considered to severely impede the competitiveness of the Victorian automotive component manufacturers is the size of regular pay rises, in addition to the uncompetitive work practices forced onto the industry.

Annual wage growth has been continuously maintained at a rate of 5% for the majority of the last decade and unions evidently want this rate to be maintained into the future. This rate is above recent Australian CPI levels and average national pay rises. Most of the Victorian components manufacturers believe unions and work forces are more interested in their pay rises being maintained in the short term rather than being able to sustain their jobs in this industry over the longer term. Participants in the case study believe that a majority of the workers do not understand the real threat to the industry, and that the global competitiveness issue is real.

Fortunately, there were a few exceptions to this issue with some organisations defining how they had very co-operative workforces who understand the competitive threats that are being experienced. Their workforces constantly focus on achieving lower cost products and remaining competitive against the import alternatives.

3.4 Other

As depicted in Chart 1 on page 17, there are several other issues impeding the competitiveness of the Victorian automotive component manufacturers identified during several of the case studies, including:

- The fluctuations of the Australian dollar;
- The cost of raw materials;
- The cost of design versus the economy of scale in Australia;
- The value of investment in Australia versus investing in overseas countries; and
- Strategic decisions (such as capital investment plans) made by offshore parent companies.

These issues are discussed in further detail within the body of this report.

3. Key issues relating to the competitiveness of the industry

3.5 Confidence in the future

The case study participants were asked to assess their confidence in their businesses' ability to survive profitably. As shown in Chart 2, 55% of respondents are very confident in the viability of their business in the short term (period of less than five years), whilst 45% expressed confidence in the long term viability of their company. The short term responses considered that there was too much uncertainty beyond five years to form longer term conclusions at this time.

Chart 3 illustrates the overall confidence expressed by case study participants:

- High – the strategies they have in place will keep their company viable;
- Medium – uncertain if they will be able to meet all of the challenges currently facing; and
- Low – the threat of low cost imports directly competing with product range.

Chart 2: Confidence of component suppliers over differing time horizons

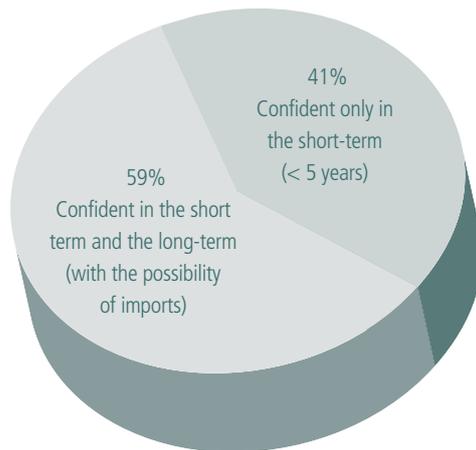
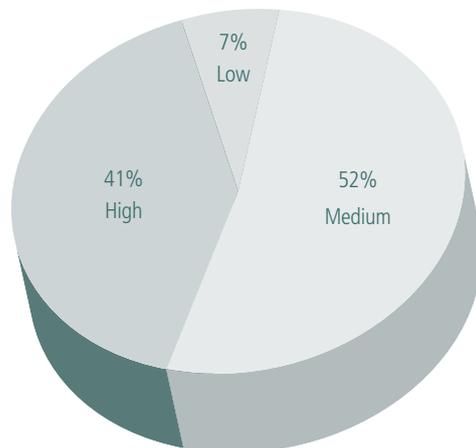


Chart 3: Overall confidence in survival of the business



4. Growth in domestic and export markets

The majority of companies that participated in the case study process and the survey are implementing strategies to enable their businesses to generate additional revenue.

Due to rising import competition, many Victorian automotive components manufacturers have already lost significant business volumes in their local markets. As a result, they are evaluating ways to maintain volumes and thereby maintain reasonable economies of scale. Most companies are primarily looking at domestic growth, as export markets are considered to be too difficult to compete within.

Removing cost from the local process was considered an imperative to support any level of future growth. It will enable local Victorian automotive component manufacturers to remain competitive, even when alternate sources of product from foreign sources becomes available to the OEMs.

The main areas identified by the Victorian automotive components manufacturers in order to attain future business growth levels are outlined below in 4.1 to 4.8.

4.1 Improved products

The main competitive advantage many Victorian automotive component manufacturers foresee for themselves in the future is to have a technological edge that results in an improved product. This requires they be a step ahead with their designs and also includes them maintaining certain products tailored for the Australian climate and the “fussy Australian consumer”.

The Australian market has unique traits and customers who are used to a certain standard of product, which calls for quite different designs to the car market in Asia Pacific, where cars are only a more recent introduction to the general consumer. A key approach being adopted to remain ahead of offshore competitors is to continue to perform local research and development, customised for the local OEMs.

4.2 Intellectual property

Many of the companies interviewed are exporting intellectual property as a key part of their survival strategy going forward. By establishing licensing agreements with organisations in low cost countries, they can licence their intellectual property and still maintain a business in Australia, with the overseas manufacturers producing their products to the specifications of those markets.

4.3 New customers

Several Victorian automotive components manufacturers highlighted that their strategy for growth involves offering their products to other OEMs. In some cases their customer base did not include all of the existing Australian OEM market, and expanding into the other OEMs is a key strategy going forward. To achieve this strategy, they are preparing in advance for the next round of model tender invitations.

Due to the high labour costs experienced in Victoria, or Australia in general, most component manufacturers are not looking at exporting components. The manufacturers with niche components are the exception, specifically where any component is needed for a short run or exclusive product, or occasionally when a parent company is short of capacity in a region. Information revealed during both the case studies and the survey suggests that the Victorian automotive component manufacturers will not be seeking to increase their export volumes as a key part of their current marketing strategy.

4.4 Diversifying the product range

There are three ways the Victorian automotive components manufacturers are looking to diversify their product ranges:

- Offering new variations of existing products to the OEMs;

- Broadening the types of products that are offered to the OEMs; and
- Diversifying into products for customers outside of the automotive industry.

The reason for diversifying outside of the automotive industry is due to the low margins currently achieved, the continual cost down pressures experienced each year and the possibility that, in the longer term, the domestic industry may not experience growth. Privately owned Australian companies were the main type of organisation looking at expanding into other industries, which would then enable them to utilise their existing machines and design expertise in other areas. Several companies are in the process of conducting market research into other industries in order to implement this strategy.

The broadening of product types that are being offered to the OEMs enables individual automotive component manufacturers to gain an advantage over their competitor, by heading towards a package or suite of products that can be sold to the OEMs. A recent example includes those organisations that are moving towards completed assemblies, or several products that connect together and thereby providing a broader product suite to the OEMs.

4.5 Outsourcing production

The results of the survey highlight that approximately 40% of component manufacturers expect to have outsourced some or all of their production processes to lower-cost countries by 2006, with the breakdown of this result considering ownership structure that 63.6% of Australian public companies are planning to outsource, followed by 42.3% of multinational organisations, and 30.3% of private companies.

There are several options to outsource manufacturing production, including:

- Sourcing parts from parent or affiliate companies;
- Providing a licence to manufacture based on their own design;
- Importing part components for further assembly or adaptation; and
- Importing product and technologies.

Each of these outsourcing methods has implications to the Victorian automotive components manufacturers. Potentially, there will be a reduction in the number and level of tier two level manufacturing, as the tier one manufacturers increase their outsourcing to overseas manufacturers. Similarly, the tier one manufacturers may need to reduce their labour force, as the import material will be partially or fully manufactured and require less value-adding manufacturing processes in the local operation.

Most survey respondents identified East Asia as the most likely location of their outsourcing operations due to the very low prices that are currently available.

Many of the companies evaluating outsourcing are assessing how they can maintain control over the process, particularly when the design is their own and the manufacturing is occurring offshore. The companies believe that this approach could keep the cost down and the quality at the standard that the local market requires.

4.6 Import components

The survey results also showed 80% of manufacturers will switch to lower cost suppliers of raw materials by 2006, many of whom will be offshore. This was supported by the case study results where 87% of participants who are not already importers, are currently evaluating or considering the option of sourcing components, both semi-finished and finished, from offshore.

Many Victorian automotive component manufacturers are sourcing cheaper import products to minimise their product cost base in order to support their growth strategy and enable them to compete with the import alternatives in the Australian market. However, the result of increased importing activities is a reduction in automotive component volumes that are manufactured in Victoria. While those automotive component manufacturers importing components may be able to remain competitive and generate positive returns on their investment, there may be less of a local labour force involved in the industry as lower tiered suppliers are omitted from the supply chain.

A large number of tier one component manufacturers are evaluating the importation of part components and then adding to them or assembling them locally. Several of the survey respondents and case study participants are multinational organisations who will import from their parent or associated companies, as a result of new production facilities being established in lower cost countries. Some of

4. Growth in domestic and export markets

the companies interviewed are seeking to transform their businesses and become import distributors as their main, or a significant proportion of the business. Companies with a significant aftermarket focus are also looking at importing components, as this type of business is well suited to importing due to the logistics processes already being established.

A key outcome from the discussions with the Victorian automotive components manufacturers who considered importing product was that they would only import quality product. A main part of their strategy therefore, is to investigate the quality produced in the low cost countries and select some key suppliers. The main products to be imported seem to be low technology, commodity products. It appears that any products that still involve technology would either be (a) manufactured in Australia, or (b) manufactured by the parent company of a multinational and then imported.



4.7 Free trade agreements

Many Victorian automotive components manufacturers were neutral when considering the benefits or risks of an FTA with the United States. Some believed it could be a benefit if the OEMs started to export more product, as that would then increase their own volumes.

The FTA with Thailand, however, had a different response from those Victorian automotive components manufacturers interviewed. Most of them considered the FTA with Thailand a significant threat due to the possibility of low cost components being easily imported into Australia. At the same time, some component manufacturers also saw this as an opportunity, as they could import low cost components themselves and add value to them locally.

There were many issues raised by the Victorian automotive components manufacturers in regard to the potential for FTAs to be introduced with other countries. FTAs are considered a threat when any country has over capacity of a certain product type, for example glass, plastic, textiles or a type of commodity product. FTAs are also considered a threat with any country that has a lower wage structure to Australia. Countries identified as providing significant threats if FTAs were introduced included Indonesia, China and most other South-East Asian countries.

4.8 Government policies

The Victorian Automotive Manufacturing Industry Strategic Plan listed several areas where industry and the government must work together in order to achieve manufacturing excellence. These included:

- Flexible and targeted business development programs;
- State government acting as industry advocate to influence Federal government policy;
- Promoting a constructive HR climate; and
- The importance of State taxes and charges.

The strategic plan also stated “Government support to industry must be geared towards recognising this reality.” The data collected in the case studies and survey re-emphasises that all of the above areas are still key and that the Victorian government needs to maintain its assistance to the industry.

The Victorian automotive components manufacturers believe there are several policy areas State and Federal governments could employ in order to assist with growth in the local industry. The most popular policies noted across all of the Victorian automotive components manufacturers interviewed included:

- **ACIS:** All Victorian automotive components manufacturers that were interviewed as part of this study considered ACIS as the most beneficial program provided by the Australian government. While some of the executives stated that they would be in business whether ACIS was available or not, many commented that ACIS had assisted their research and development capability to a level that gives them a competitive advantage against many of the products that are manufactured in off-shore facilities.

All executives agreed that the continuation of ACIS would help to maintain the competitiveness of the local industry. In particular, it was noted that ACIS helped to overcome the economies of scale issue in Australia, as local volumes are far too low to support the full development costs that are incurred by local automotive components manufacturers.

The prevalent negative feedback expressed by case study participants regarding ACIS relates to the OEM ACIS claims. The Victorian automotive component manufacturers believe that the OEMs should not be

provided with ACIS support when they plan to use it for the development of products that will utilise imported components. Given the Federal Government allocation to ACIS, the Victorian automotive component manufacturers expectation is this scheme will be applied to support entire Australian automotive manufacturing industry, and not be specifically diverted towards the OEMs.

- **Workplace reforms:** Any government policy change that can assist with the reduction to the cost of labour is considered a great assistance to growth within the local industry. There are many areas that this could incorporate, but industrial relations, payroll tax and WorkCover structures were predominantly identified.

The 38-hour working week, with rostered days off, was also considered to be a cost that the industry can no longer afford to support. Several companies suggested that work place reforms in this area would also support the industry’s ongoing competitiveness and sustainability.

- **Tariffs:** Many of the case study participants highlighted that the local industry believes tariffs are necessary to protect against the advantages that the low cost countries have generated in recent years.
- **Export Grants:** Several companies expressed concerns regarding the limitations involved with the export grant schemes. In particular, some of the smaller companies stated that the assistance they needed when considering exporting is necessary in the very early stages, as they are trying to get the project off the ground, not at the back end of the process when the assistance is provided. Others suggested that the conditions to obtain assistance from the scheme are too limiting to make it a useful program.

Several companies made reference to the environment that the government needs to create in order to more effectively support manufacturing. The majority of these references came from companies with multi-national parents. In many of the low cost countries where manufacturing industries are rapidly growing, the relevant government is treating manufacturing as a key growth industry. This gives these countries an advantage due to the level of support they receive. Within Victoria, several of the component manufacturers feel that the prevailing environment mitigates opportunities for growth in manufacturing and that it is being treated as a sunset industry.

5. Innovation

Innovation is recognised as a critical factor in sustaining the competitiveness of the Victorian automotive component industry.

In the strategic audit performed on the Victorian automotive manufacturing industry to support the strategic plan issued by the Victorian Government in December 2001, it was found that “Component manufacturers will be required to lead new technology developments in order to retain existing supply contracts.” The results from the survey and case studies show that the industry still agrees with this conclusion three years later, in 2004.

Almost all companies interviewed during the case study program highlighted that the R&D process is a key strategy for them to maintain their competitiveness in the current environment, as well as providing opportunities to grow into future markets.

Most companies believe that the competitive advantage derived by the local Victorian manufacturers is due to their engineers being on the ground in the local environment and nearer to the OEMs. These engineers are therefore able to work closely with the OEMs to develop and design the products to suit the local platform. Local product development is considered to be extremely advantageous, as changes occur and flexibility is needed to support the process as it develops. This element and the local logistics capability are considered the two key advantages that the local Victorian automotive components manufacturers have over their offshore competitors.

Australian development also tends to be cheaper than the development costs incurred by the European or American counterparts. This provides Victorian automotive component manufacturers with an opportunity to remove cost from the product and to develop smarter products and processes going forward. As a result, the OEMs are very supportive of local design.

The main research and development plans of Victorian automotive component manufacturers over the next two years involves:

- New products;
- New technology; and
- New production processes.

Most of the companies involved in the case studies emphasised that the majority of their R&D investment relates to the development of new products, or for the tailoring of parent products to suit the local industry. A significant amount of development is also being used in the current environment to explore opportunities to remove cost from products. The alternate approach is to design additional product features for no extra cost.

A large amount of R&D spend is planned for new production processes, or optimising existing processes. This is vital for cost reduction going forward to ensure that Victorian automotive component manufacturers maintain their competitiveness.

The utilisation of new materials for existing products is another key R&D consideration, especially materials that are lighter, recyclable, produce less scrap or have other advantages for both the OEMs and component manufacturers. This is seen as a key part of the competitive edge going forward. The development of products that are more environmentally friendly is currently also considered as a key growth area requiring innovation. One aspect of focus is to increase the life span of a product to reduce waste, or move towards recyclable components.

Most of the multi-national organisations primarily use their parent’s R&D results with some local tailoring. However, private companies are more reliant on internal R&D processes to drive future sales growth, according to the survey and case studies.

Effective management of the total supply chain is expected to provide significant improvements to the industry's overall competitiveness. There is scope to implement further change through all levels of the supply chain.

6.1 Suppliers

- Many component manufacturers currently work with their suppliers to help reduce the cost of their products. Some tier one manufacturers resent having to help the other tiers achieve this outcome, while others believe helping the suppliers was the best way for them to remain competitive, as it assists in eliminating cost from their processes. Hence, there is a very mixed industry approach to dealing with suppliers.
- The tier one component manufacturers believe that the lower tier suppliers do not have the same efficient approach or understanding of the OEM standards, and that this is essential to enable them to achieve OEM standards without introducing more cost. They believe that the competitive imports will reach OEM standards in the near future and it is essential that the lower tiers in Australia also get to this level.
- Several tier one component manufacturers felt that their suppliers are not sufficiently innovative and do not initiate ideas on how to remove costs. They consider that while they are constantly achieving this and passing savings on to the OEMs, they are not receiving similar service from their own suppliers. This was summarised by one tier one manufacturer that there is less professionalism amongst the lower tier designers.
- The lower tiered suppliers believe that their customers (tier ones) are continually requesting rapid and constant cost elimination. Some tier ones are planning to introduce purchasing policies similar to the OEMs and therefore their suppliers need to improve or they may lose business. As there are more import alternatives becoming available, the tier ones' position will continue to gain strength and this is seen as a major threat to the lower tiered suppliers.
- Some of the tier one manufacturers suggest that the

reason the lower tiered suppliers are not as adept at eliminating cost out of their processes, is that their businesses are not purely automotive, and they are dealing with a broader range of customers. Hence, they are not as understanding or aware of the cost pressures that the OEMs are continually applying to the tier one suppliers.

- Several companies have tried to create alliances with their suppliers, without a lot of success. However, they consider that there may be more opportunities to do this going forward, as the industry faces more competitive pressures. Strategic alliances with offshore suppliers are also being considered.

6.2 Customers

The case study respondents confirmed a large level of improvement is needed between them and their customer. The key customer issues faced by the Victorian automotive components manufacturers include:

- The OEMs can be quite disruptive and interruptive (with many of the changes that are made to their schedules). This issue makes the ordering of raw materials and stock-keeping difficult for many of the component manufacturers;
- The Victorian components manufacturers' sales teams spend a lot of their time managing "endless" customer enquiries;
- While some OEMs work with their suppliers to plan for future success, others have no commitment to their volumes, with mid contract price benchmarks being employed;
- "The car industry is a nightmare" when it comes

6. Suppliers, customers and competition

to dealing with the issues of exchange rate and raw materials price fluctuations. Some customers allow banding in their contracts, which gives the Victorian automotive component manufacturers some protection when the exchange rate goes outside a certain range. The OEMs seem quite keen to get their share of benefit when the exchange rate moves in their favour, but are not as keen to contribute when the rate fluctuates the other way. The risk for exchange rate fluctuation is predominantly worn by the component manufacturer.

- The OEMs want fixed prices for three years, which are usually established two years before the model starts to be produced. The difficulty for the component manufacturers is that the raw materials are globally priced and change constantly, based on supply and demand. However the OEMs are not willing to accept this cost variance;
- Local supply of raw materials does not give the local users an advantage as the materials are priced globally with freight not taken into account, so the overseas competitors have the same cost structure for raw materials;
- The time that it takes to validate a product change causes a considerable delay when the component manufacturers wish to introduce cost reduction initiatives. The testing processes of the OEMs can make the change a lengthy process;
- The OEMs release new models every four to five years. During the latest round of model changes, the component manufacturers found that their import competition was much higher than the previous model tenders. Many component manufacturers are concerned about the next model round expected in another five years time and how the low cost countries will have a significant advantage by then, as their quality and technology will have improved substantially;
- The complexity of the model mix within the Australian automotive industry is significant and is designed to meet consumer trends. The number of variations to each model platform is high, particularly in the context of a small market size. The complexity has certain advantages for the Australian component manufacturers, as well as disadvantages. It is an advantage as it makes it very difficult for imports to match the complexity of the model mix. As the car companies do not know exactly which variations they

are going to sell, it is difficult for them to pre-order large amounts of import materials.

The Australian component manufacturers can manufacture niche products and short-run products for these complex model mixes. However, the complexity also causes issues for the component manufacturers, as they continually have to change their manufacturing processes and the inefficiencies of the OEM schedule changes continue to add to the overall cost of the product; and

- Communication between the design groups of customers and suppliers is considered an issue in some cases. The concern relates to the OEMs that are seen to be repeating design and/or testing work that the component manufacturers have already completed, which adds cost to the overall process.

As a result of these issues, the component manufacturers find it difficult to remove unnecessary costs from their processes and maintain competitiveness in the local environment.

6.3 Price reductions

The survey results highlight almost nine in ten Victorian automotive component manufacturers have been forced to accept lower selling prices. The survey found that the average decline in 2003/4 was 5.5% with an expected further decline in the next two years of 8.4%. The case studies supported this data with all of the participating manufacturers having experienced a price reduction. The raw materials suppliers were the only exception to this.

Of the companies who participated in the case studies, the average price decline in the last 12 months was 7.8%, with more requests for price reductions continuing. The variation in price reductions was from a low of 2% up to a high of 40%. For multinational organisations, the price reductions averaged 5.4%, public companies 7.5% and private Australian companies 9.5%.

All of the participating Victorian automotive components manufacturers concluded they could not withstand further price reductions with their existing cost structures and processes, and that they would actively seek to rebalance this position. Where necessary, products would be withdrawn from their offerings, especially where they were no longer profitable to maintain.

6.4 Competition

The imported competition arrives from many regions. The surveys and case studies both indicated that South East and Eastern Asia were the main source regions from which components manufacturers experienced the most competition. However, South Africa, South America and a limited number from Eastern Europe were also identified as import competition.

Each time a tender is released by an OEM there are several offshore competitors that are asked to participate in the process. The number of offshore respondents per tender varies from three, up to twenty. While a large number of companies are involved in a tender, it is the belief of the Victorian automotive components manufacturers that only two or three of the offshore manufacturers are real competitors, who would actually have the ability to supply the product to the schedule and quality required by the OEMs. The other suppliers were believed to be invited only to create greater competition in support of lower prices.

Most Victorian automotive component manufacturers indicated they had limited local competition in the market place, due to the large amount of consolidation that has already occurred within the industry.

The exchange rate fluctuations have had a major impact on the Australian components manufacturers. When the Australian dollar is as strong as it was in early 2004, the impact on Australian companies is extremely significant, especially the impacts on competitiveness and profitability. They each find it very difficult to remain competitive with importers, and experience a large negative impact on their export market volumes.

6.5 Globalisation of the industry

According to the Victorian automotive component manufacturers, increasing globalisation experienced by the automotive industry has given rise to the changed purchasing strategies of the OEMs. The global purchasing practices adopted by some OEMs involves the determination of the cheapest ex-works (non-delivered) product source, and then requiring their current suppliers to meet that price regardless of their manufacturing location. The OEMs are beginning to benchmark prices mid-contract, using a similar technique and trying implement additional costdowns prior to the end of the model run.

In the next round of model designs, it is expected that several of the OEMs will have vehicles that are made on the same platform in several locations around the globe. This will lead to an increased number of globalised purchasing strategies. Private Australian companies are finding that they are unable to compete in this global supply sourcing process due to capacity limitations. However, the multi-national organisations with both local and lower-cost foreign presence are finding themselves in a much stronger situation. The survey identified that all but one participant reported that the procurement policies of OEMs are having an adverse impact on profitability in 2003/04.

The multi-national organisations are finding globalisation an overall disadvantage, as they retain their volumes at reduced prices. The global purchasing strategies of the OEMs utilises the economies of scale achieved by their suppliers to achieve an improved price. Hence, the profitability of the Victorian automotive component manufacturers has reportedly diminished, based on the global price that is being negotiated by the foreign head office.

6.6 Overall supply chain improvements

Improving the overall supply chain is a major focus for many component manufacturers. Several observed that the process could be enhanced with meetings, with all parties involved in the supply chain, per product area of the vehicle, in order to discuss forthcoming changes and issues.

Currently, the OEMs communicate change to the tier one, who then process the information down the chain, ensuring that it is received right through to the raw material supplier. The majority of participants confirmed that the efficiency of this process needs to be significantly improved.

7. Workplace and skills

Skill shortages are a problem for the local industry and may become one of the key elements impacting industry competitiveness.

The majority of component manufacturers expressed their concerns relating to the various skill shortages within the industry. A wide range of skill shortages were identified, ranging from process workers, trades to engineers. However, only a limited number of survey respondents identified that the skill shortages are a significant issue currently impacting their overall competitiveness, but that it is likely to have more of an impact in the future.

The main areas identified with immediate shortages are the engineers and tradespeople. Engineers with industry design experience are considered to be in short supply by most case study participants, and some regarded the availability of process engineers as also being limited. The shortage of experienced trade personnel included electricians, fitters, and tool-makers who were commented on specifically, as the trade is no longer taught at a local level and appears to be moving entirely offshore.

The small number of apprentices currently working in the automotive industry was seen as a major concern and that in future there would be even less tradespeople based on the perceived unattractiveness of the industry. The industry is struggling to attract talented young people because of issues around longevity. Finance and sales departments also have skill shortages, as the automotive industry does not appear to attract the high performers or large numbers of applicants in these areas.

Several case study participants commented on the perceived lack of glamour associated with the industry. Key reasons for this include ignorance regarding career prospects, the uncertainty of the future of the industry, and the general image of working in a “factory”.

Many case study participants commented on the lack of quality and talent available across all skill areas and that the education system was letting the industry down. The people employed were not perceived as having high problem solving skills nor the right attitude to tackle new problems, preferring only to manage tasks that they have previously experienced.

The perception of work ethic varied considerably throughout the industry. Absenteeism is an issue experienced throughout the industry and is considered to be part of the work ethic that challenges many of the Victorian automotive component manufacturers. However, many small private companies commented that they had a very co-operative workforce that is willing to grow and change where required.

Many of the larger companies, however, experienced the unionised attitude of the workforce, constantly after pay rises for little gain in productivity. The larger component manufacturers experiencing these issues tended to be companies that had acquired many businesses over time and are exposed to a mix of work place cultures that contributed to these attitudes.

The companies who had a positive work place culture had:

- Regular communication between management and all employees regarding the company direction; and
- A culture of accepting ideas for change from all levels of the organisation, some with incentive schemes attached to employee innovation.

Companies that are actively responsive to employee’s suggestions commented that they had been able to take significant cost out of their processes as a result of some of the suggestions provided by their employees.

7.1 Industrial relations

The Victorian Government’s strategic plan outlined that the industrial relations climate is critical to the industry’s capacity to cope with future challenges. It is important to ensure that the government, industry and unions, all understand the challenges involved. Sound industrial relations can make a major contribution to the competitiveness of the industry. In 2004, component manufacturers

continue to agree with these sentiments, however it seems that there have been varying levels of success in the last three years in achieving the understanding needed.

Some component manufacturers highlighted that their enterprise bargaining agreements limited their productivity. The two main areas of EBAs that limited their competitiveness include:

1) The continuous pay rises of 4-5% per annum insisted upon by unions. The OEMs continuously provide pay rises of this size to their employees and set the standard for the entire industry. The component manufacturers responded that they are unable to let their wage negotiations proceed to a dispute, as this would cause down time, at a significant cost to their business, and therefore unwillingly accept these standard industry rate rises; and

2) The limitation where component manufacturers are not able to have casual staff on-site. Several case study participants commented that this was an issue in times of high demand, when the OEMs are demanding substantial volume, that they cannot bring on extra people to keep up with the demand increase. As a result, they need to carry more inventory and/or pay for more overtime shifts, which erodes their competitiveness and profitability.

A significant concern for many of the executives interviewed is the request made by unions to have redundancy payments made available (in the bank) as part of the enterprise bargaining agreements. While not mandatory at this stage, it may certainly cause major financial issues for several of the smaller private companies. The executives insist that the unions should help to retain the jobs that already exist, rather than focussing on what may happen to the employees when their jobs are made redundant.



8. Capital investment

The automotive industry is highly capital intensive with very significant equipment costs. The study has identified that the industry is planning to continue investing in Victoria.

Many of the larger component manufacturers have already undertaken significant capital investment in the last few years to help reduce labour costs, and/or to expand operations in order to meet the automotive manufacturing growth in Australia. Most of the multi-national organisations are currently able to present a solid business case for investment, however that is proving more difficult when investment returns are being compared to the lower cost countries. Less Australian investment is expected to occur in the long-term as the foreign parent companies now have more attractive regions in which to invest and achieve greater returns.

Local planned investment relates to new technologies and processes, or to support other mechanisms of increasing productivity, which is consistent with the cost reduction strategies outlined by many of the case study participants. It is expected that the new investment will result in a capacity increase due to improved productivity. Some of the investment is for new work on the upcoming model ranges that are expected to be released in 2006.

The survey reveals spending on new capital equipment is budgeted to increase by 16.2% over the next two years, split as follows:

- Australian listed companies (34.1%);
- Small and medium private enterprises (13.6%); and
- Multinational organisations (1.7%).

The case studies further reinforce the fact that the multi-national organisations plan to reduce their level of future investment provided in the Victorian automotive component manufacturing industry over the short to medium term.

Many of the smaller, private companies identified that they are reluctant to invest in the current environment when they cannot obtain long-term contracts with the

OEMs. Even when they do obtain contracts, the OEMs benchmark their prices with low cost countries half way through a model, and potentially withdraw the business. Some of them are, therefore, hesitant to invest in equipment for new models, as they are uncertain on the return in that investment over the long term. The main investment made by some of these smaller companies is for maintenance and productivity improvement of the investment that they already have, rather than investing for growth. The productivity improvements are expected to provide further capacity gains by achieving higher levels of efficiency.

Boards and financiers require a commitment to volume in order to provide finance to support new investments. With the new mid-contract benchmarking process, and recent examples of changes being introduced mid-contract, some Victorian automotive component manufacturers believe that it may become difficult to present a strong case for future finance commitment.

For most Victorian automotive component manufacturers, borrowing money has not been an issue to date. The strength of internal cash flows has supported applications for capital. However, they are finding that their gearing levels have increased and if this trend continues, borrowing may become an issue that impedes growth and their ability to remain competitive. The Victorian automotive component manufacturers believe that their Boards and financiers need a commitment to volume before they will commit to the finances and capital investment, which places some of them in a very difficult position in the short term.

All of the Victorian automotive component manufacturers that participated in the study are looking at various ways to enhance productivity, and remove cost from their business.

Reduction of costs is considered a vital strategy to enable the component manufacturers to grow their business. Without cost reduction, the component manufacturers believe they will find it increasingly difficult to grow their businesses with the large amount of competition that is emerging at present.

Most component manufacturers believe that if they make changes to their cost structure, they could meet the cost-downs required by the OEMs. The main opportunities being investigated to reduce cost include:

- **Product range rationalisation:** Removing some products from their range that generate negative returns and whose capacity can be replaced by positive margin products that are currently in demand.
- **Procurement policies:** This involves the evaluation of lower cost suppliers, and in particular, imported products. This is quite significant for the tier two, tier three and raw material suppliers in Australia, as it may significantly decrease their volumes in the long-term.
- **Labour costs:** Are considered a significant issue for the majority of companies and automation is being introduced to remove labour costs where possible. This initiative involves significant capital investment and is going to lead to significant labour cost reductions throughout the industry. Some companies are assuming that this will happen by natural attrition and are planning not to replace employees, whilst others are planning to reduce large numbers with the introduction of automation.

The labour cost component is considered a major part of most product differentiation. When the cost per component is broken down, the actual cost for raw materials and other areas will be similar for all manufacturers despite their location, but it is the labour cost that will be the main area of difference between competitors. There were a small number of case study participants who were not particularly

concerned about their labour costs, however they have either significantly automated their processes or have a low labour cost relative to the other costs in their products.

- **Review of production processes:** Many companies currently utilise or are planning to utilise tools such as six sigma and lean manufacturing to help remove costs from their production processes and improve their overall efficiency. Over half the survey respondents confirmed that they are using lean manufacturing in their main production processes but have yet to migrate these principles to their back office processes.

Six Sigma is being utilised, primarily by the multi-national organisations where the parent company has introduced this tool globally. Lean manufacturing is being utilised more broadly throughout the Victorian automotive component manufacturers. Many executives stated that they utilise segments of these tools without necessarily introducing the full suite of the product into the organisation.

- **Economies of scale:** Several companies identified economies of scale as being a key issue going forward. With the volume of the Australian market being so small, the cost of overheads and design is divided over a smaller volume, which significantly increases the cost per part. The volumes to support economies of scale in Asia and the USA are significantly larger, and support a more competitively priced product.

The economy of scale issue is further amplified due to the small number of OEMs in Australia. The loss of business from one OEM could cause an economy of scale issue for some local manufacturers with volumes actually diminishing to unprofitable levels. This is quite concerning given the stability of the OEMs within the current Australian market.

Similar to the findings from the Ai Group survey, the case

9. Costs

studies confirmed most companies are relatively comfortable with their competitiveness in the next two- to three years. A key element of their stability is a result of their work focusing on existing models, and preparing for the next model production run, where most of the decisions have been finalised by the OEMs.

However, the case studies revealed many of these companies have major concerns beyond 2006. Their concerns relate to the quality improvements and economies of scale that the low cost countries in Asia are expected to achieve in the short term. They believe that it is like a “time-bomb ticking away”, as time goes by, these countries will improve their technology and quality of products and be able to export into Australia at a much more competitive rate.

Many of the local manufacturers are considering where their business will be in five years time. Local industry understands the need to remove as much cost from their processes as possible, in order to remain competitive in excess of a two-year timeframe. There is a large amount of uncertainty regarding the impact of an increasing availability of imported components (particularly from China and other Asian producers) on OEM purchasing decisions. Some Victorian automotive component manufacturers question the extent to which future new models utilise local components in such a competitive environment.

9.1 Inventories

The majority of companies involved in the case study commented that they had made reductions to all inventories: finished goods and raw materials, in the last decade. These inventory reductions have had a significant positive impact on cash flow and working capital balances, leading to overall cost savings. A small number of case study participants stated that the reduction in inventory had led to an occasional “stock-out” situation, but that this had not been a significant issue.

Conversely, several of the case study participants are experiencing an increase in their raw material inventory levels primarily as they begin to import more materials and part components. Due to the longer lead times associated with purchasing import components, and with more possibilities of delays, they are finding the need to carry more inventory. As more component manufacturers explore import alternatives to reduce cost, inventories may rise.

9.2 Outsource logistics

The survey results identified less than one third of Victorian automotive component manufacturers expecting to have outsourced their logistics processes by 2006. However, only 40% of participants are planning to link more closely with their distributors.



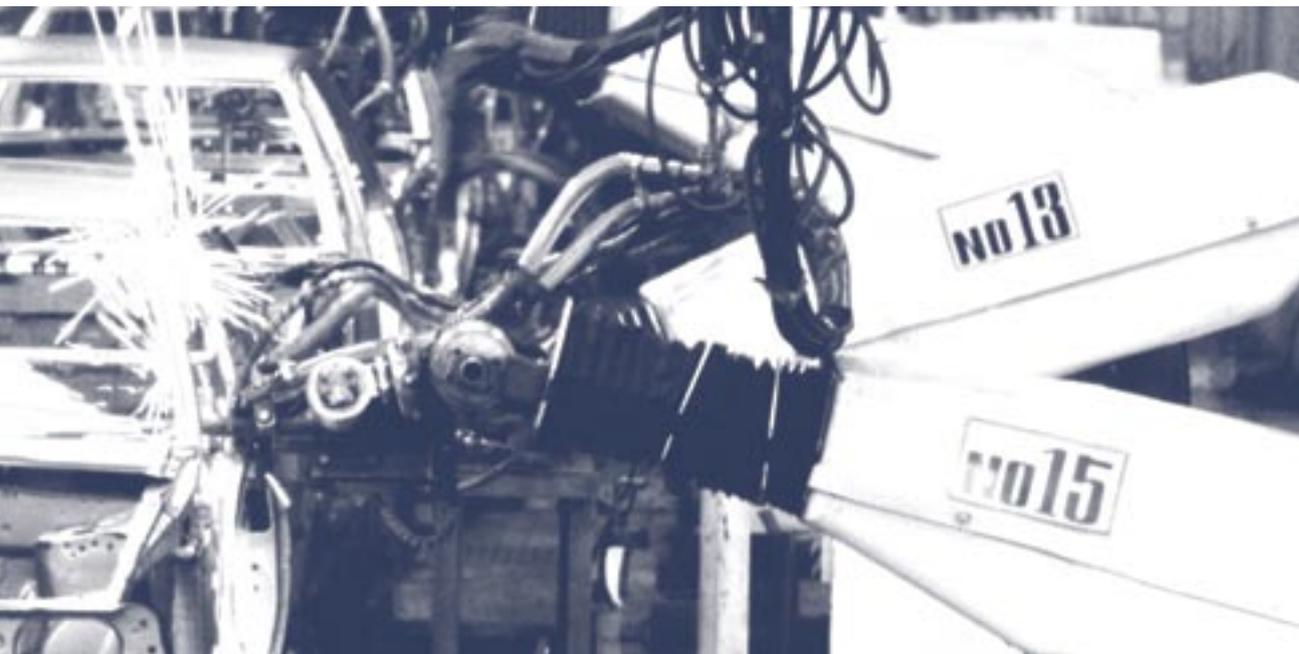
The case studies identified the majority of participants outsource the transport and distribution side of their logistics. In many cases this was due to the OEM processes and using the “milk-run” collection system that the OEM’s have established. However, most had retained internal responsibility for managing their warehousing function, and have no plans to change that in the short term, supporting the survey results. Several participants highlighted that they are currently conducting reviews of their warehousing and logistics and will determine from the results whether to outsource in the future.

Of the companies that have outsourced all of their logistics processes, the service level had increased, however, it had taken a longer period of time than expected in order for these benefits to occur.

9.3 Consolidation, mergers and acquisitions

Many case study participants stated they were always considering mergers or acquisitions when the opportunity is available. They consider this a strategy going forward that will assist to increase the economy of scale and reduce overall cost structures, therefore supporting their competitiveness.

Many of the tier one executives stated that consolidation should continue to occur in the tier two level of the industry to assist with the cost structures of their supply. This would involve either mergers, or in some cases tier one manufacturers acquiring them. The tier one executives believed the tier one level of the industry is already consolidated to its maximum, without major industry restructuring.



10. Manufacturing growth in China

China has recently experienced rapid growth in manufacturing, particularly in automotive components and vehicles. The impact of this growth on the local automotive industry is uncertain, however the study was able to identify opportunities and threats that the stakeholders believe are significant.

According to the 2004 Ai Group report, “Australian Manufacturing and China”⁽²⁾, the rapidly expanding Chinese economy is changing the environment in which the Australian industry competes. The report stated that China has emerged as a major competitor in the export and domestic markets of Australian firms, with an extremely low wage and cost base as a key competitive driver (page12).

Fears of over-investment in the automotive sector in China continue as manufacturers continue to plan for increasing production capacity over the next five years. The total planned capacity additions of the major vehicle manufacturers exceeds the total level of 2003 sales in China. However, it remains uncertain if all expansion plans are going to be realised or whether they will be adjusted to suit changing market conditions.

China is still largely a domestic market, where imports and exports of vehicles are low. However, exports of component parts accounted for almost half of China’s production. Vehicle exports will take some time to grow for a variety of reasons including quality standards, access to distribution networks, foreign vehicle manufacturers not yet wishing to cannabalise their other markets, and China not yet creating a significant cost advantage for its produced vehicles. However, it is believed that China will be a strong contender for vehicle exports within five years. Components on the other hand, will be heavily exported in the short term.

The component manufacturing industry in China relies heavily on imported technology. Currently, there are local content rules which are forcing many companies to establish operations in China so that they can sell their

components to the OEMs. These local content rules are only in place for the short term.

Several component manufacturers have also commented on the advantage generated by Chinese manufacturers, due to their exchange rate being linked to the US dollar. They do not have the same fluctuations in their currency affecting their competitiveness or profitability.

10.1 Opportunities

Some automotive component manufacturers expect there to be opportunities arising from the manufacturing growth that is currently experienced within China. Some companies have funds and capital to invest overseas in order to participate in this growth. Others, however, perceive the advantage will arise from being able to provide their intellectual property to China.

The Chinese market does not currently have many technologically advanced products and the Victorian automotive component manufacturers perceive themselves as sellers of technology to Chinese manufacturers. However, the Victorian automotive component manufacturers do not believe that there will be many opportunities to export actual components to China.

The other area of opportunity for the Victorian automotive component manufacturers will be realised when some manufacturers are able to import cheaper components from China, once the Chinese quality issues are ironed out. This will then allow the Victorian automotive component manufacturers to remove some cost from their products and help improve their competitiveness.

(2) “Australian Manufacturing and China”. Australian Industry Group. Melbourne. 2004.

in China is the only way that they can continue business into the future. Others believe that their only mechanism to compete was by owning their intellectual property and controlling the manufacture of the product offshore.

The tier three and raw materials suppliers feel that they may have no customers in the future as Chinese manufacturing eliminates their tier one and tier two customers. The tier one and two component manufacturers also feel threatened by the Australian OEMs having the ability to import assemblies directly from China.

There are some tier one suppliers who are not threatened by China's growth, as their product is logistically difficult to import. Several tier one component manufacturers are looking at providing a complete package to the OEMs, which is a difficult area for offshore component importers to compete.

The main belief of the Victorian automotive component manufacturers is that China is a significant threat in approximately five years. This period of time gives the Chinese component manufacturers a chance to enhance their quality capability with support from the OEMs, filter the improvements through their production techniques and provide enough volume to support their economies of scale, which may then outstrip the domestic market demand, and enable the export of significant volumes of low-cost product to Australia.

10.2 Threats

The majority of companies interviewed believed that the growth in the Chinese manufacturing industry will directly threaten the Victorian automotive component manufacturing industry. They believe that this may even see the total demise of the local industry. Some even predict that there may not be a local automotive industry in Australia in the future, including the OEMs. However, they did believe that some research and development process could remain in Australia.

There were suggestions that the automotive industry is perhaps going through a similar experience to the textiles industry, where in the last decade, the majority of the manufacturing industry moved offshore, due to lack of competitiveness with imported product. The Australian textiles industry is now primarily design, sales and distribution.

As a result of the perceived threats many local companies have changed their strategies. They believe the threats are not only generated from China, but also the growth in other low cost countries in the Asia Pacific region. Growth in this region has influenced their production volumes and techniques, the amount that they are willing to invest in their technology and their future headcount.

The local component manufacturers believe that the main approach to competing with China in the future is to maintain local engineering, which is highly technical and of a high quality. They also need to remove as much cost from their process as possible, particularly in the labour cost area. Some believe that investing in a joint venture





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