

Devious Deviations – RFQ Volumes Often Defy Logic

Request-For-Quote / Quotation, also known as RFQ in industry parlance, is an integral part of OEM-suppliers relationships. They are the life-blood of a component supplier's business development and sales activities. The numbers that an OEM projects in an RFQ provide the foundation of business planning for the supplier. These numbers often decide what the supplier would quote in terms of price for supplying the component / module and what the finer terms & conditions of the supply contract would be.

The relevance of RFQ numbers goes even further. The numbers on any program are often one of the important criteria for deciding on planning production, increasing the capacity and even setting up a new manufacturing plant. The RFQ numbers and their historical accuracy for any OEM are often also the basis of negotiations between the supplier and the OEM for any future model programs.

Accuracy of RFQ numbers should be sacrosanct then?

Not Really.

A cursory glance at some of the recent RFQs reveals that the initial volumes projected by OEMs are often way-off mark. At times the deviation is so severe that it is hard to believe that the supplier's profitability was not impacted.

At times, so severe are the deviations that if the suppliers took all the RFQ numbers at face value without running their own internal forecasts, we would have spent the better part of this analysis discussing the financial health of automotive component suppliers.

The Process

OEMs typically ascertain supplier readiness during Production Part Approval Process (PPAP) evaluation. A part of the PPAP evaluation process involves ensuring that suppliers would have reasonable capacity to match peak, expected demand.

Needless to say, Tier-I's are supposed to ensure that sufficient capacity is available at Tier-II and Tier-III levels for sub-assemblies.

Theory vs Reality – two Scenarios

In a perfectly theoretical world supplies would start with pilot volumes and would quickly ramp-up to reach almost peak volumes. Then they should plateau for many quarters after which there would be a slow tapering marking the end of the product lifecycle. Some mid-life spurts would be provided by the usual headlamp-bumper-tail lamp tweaks.

But as we said, this is a perfectly theoretical world. Reality is often very different and is often one of the following scenarios:

Scenario I is the Dream scenario where the OEM has underestimated the expected volumes of the car and often the initial rush means that there is a waiting list for new models stretching into months. In this case, the OEM, and in-turn the suppliers, are caught off-guard and have to ramp up production in a hurry.

Scenario II is the Nightmare scenario in which there is no initial rush, no buyer interest and poor demand for the car model. That means that the OEM has idle capacity and the supplier too is forced to turn off the tap.

Both cases are the result of underlying bad forecasting and estimation of the market & product demands. Both scenarios also potentially cause a lot of heartburn and anxiety

elevation for suppliers' managers.

However, Scenario I often results in better annual bonuses.

RFQ Volumes – Types of OEM-supplier agreements

Supply agreements are meant to lock-in prices. OEMs and suppliers often design supply agreements in multiple ways depending on the type of component, the relevance of each party in the development and tooling of the component and even the existing relationship between the OEM and supplier.

For non-proprietary components, the agreement often splits costs between raw material and processing. There are additional articles in the agreement covering how costs involved with logistics and foreign exchange volatility would be handled. Most OEMs allow their suppliers to review their prices in the event of significant hardening or weakening of raw material prices but any request for a price hike on account of an increase in process costs is usually turned down. The underlying belief is that suppliers are required to improve productivity over time and reduce costs through value engineering/ value addition and through economies of scale achieved by way of higher volumes that OEMs source from their suppliers every year.

But while locking-in prices, OEMs often do not lock-in volume. Most supply agreements indemnify OEMs from any losses the suppliers are likely to incur in the event of lower than expected demands.

The only cases where suppliers get a volume commitment are when they are expected to setup a dedicated unit to support the OEMs operations.

The legal and financial dynamics of proprietary components (tyres, batteries, fasteners etc) sourcing are different. Since the supplier in this case is also the technology and design owner they compete mostly on performance and to a

lesser degree on cost.

Moreover, since proprietary components are shared between several programs amongst several OEMs their business prospects are aligned to overall sectorial performance, as long as they don't run a captive facility for an OEM. Further, they usually get to market their components in the aftermarket, which brings them significantly higher revenues.

Deviations in RFQ volumes – Can happen on the lower side as well

Not all RFQ volume forecasts are fictional numbers dressed to keep the senior global management in good humor. Deviations from actual numbers often happen due to unintentional bad planning, wrong forecasting or over enthusiasm from the OEM management.

While the operative principle is to ensure sufficient production capacity at the supplier's end to meet peak demand for the vehicle, a minor increase in projection helps OEMs in increasing production smoothly should a model receive an unexpectedly large retail response.

However, even that may not be enough.

Analysis of several successful production programs shows us that sometimes OEMs can seriously underestimate production volumes. Take the case of Mahindra XUV500 – Mahindra had initially projected peak demand of 2,000 units a month but ended up churning out more than twice the number after an overwhelming response to the crossover. The company still continues to exceed RFQ target volumes of 2,000 units a month – managing anywhere between 2200-2400 units, as per media reports.

Or take the case of the last generation Swift D'Zire – it always faced the challenge of meeting customer demand with production often lagging behind sales by a few months.

Higher RFQ Volumes – Mischievous, Malicious or Unintentional

But these (lower RFQ volumes) were unique cases, more of anomalies than regular practice. Mostly the industry faces a shortfall of actual volumes as compared to RFQ volumes. This is a widely prevalent problem in the Indian industry and at times it may be an intentional

At times, the real reason of projecting larger volumes in the RFQ is to extract lower fixed prices of components from suppliers. Since projections are just projections and not commitments and since at the time of releasing RFQs, suppliers cannot ascertain the positioning, pricing, looks and aesthetics that the OEMs plans to achieve with the product, the component prices must be quoted based on rather ambiguous assumptions.

Often this ends in disasters like Tata Nano and the Nissan Evalia.

Having matured through such debacles, suppliers have become wiser and are often increasingly skeptical of RFQ volumes every passing year, discounting significant volume projection from every RFQ that lands on their table.

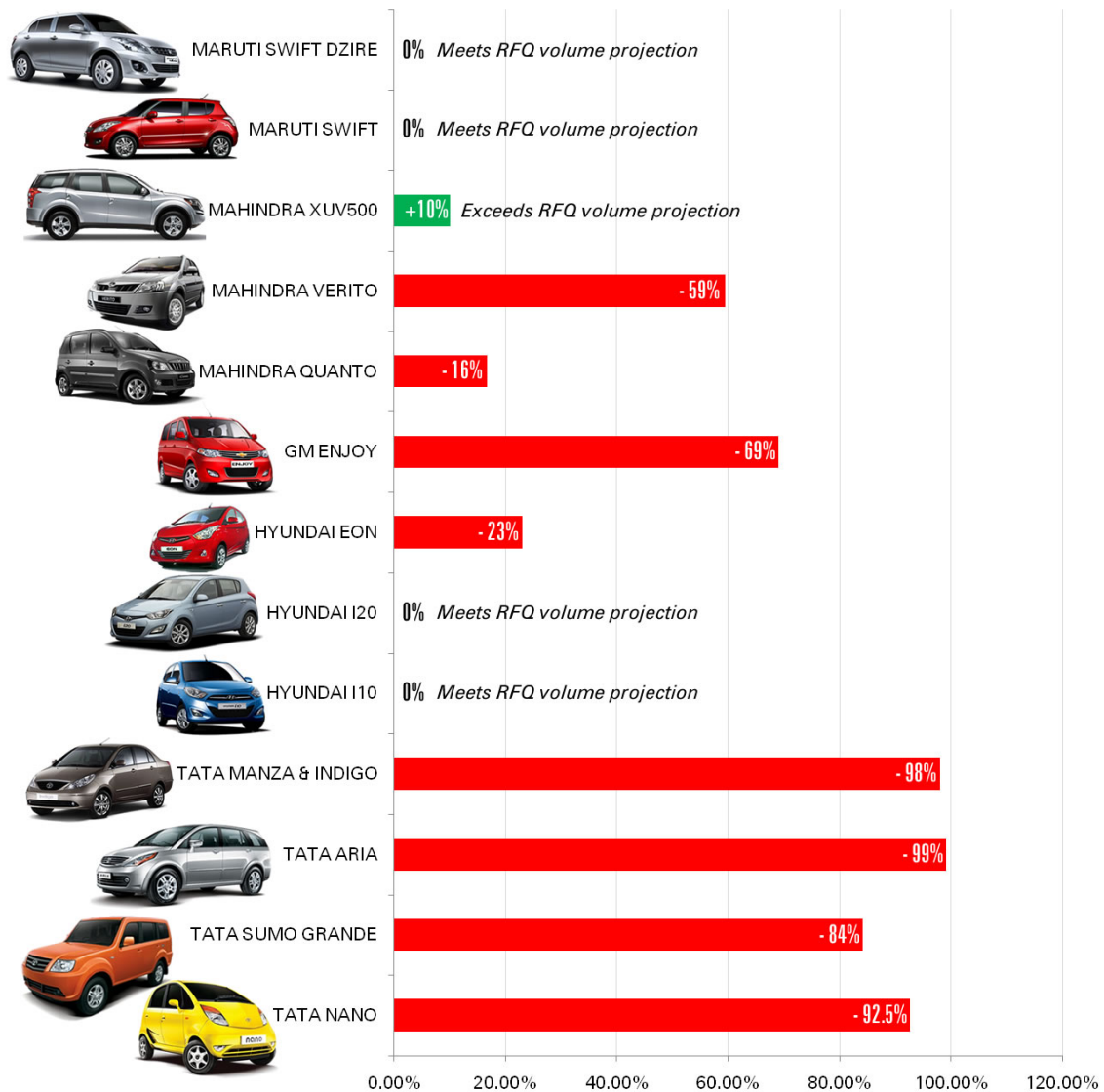
Which often leads to an unintentional, amusing and problematic situation.

OEMs, knowing that suppliers will chop away at any numbers they throw at them in an RFQ, tend to fantasize hyperbolise numbers even further. This is done to ensure that suppliers still have sufficient capacity after chopping away numbers furnished by the OEM.

When EMMAAA did the analysis of comparing RFQ numbers with actual volumes, some RFQs came out widely out of line from the actual market volumes. We also noticed that domestic OEMs often see more RFQ volume deviations as compared to global OEMs.

DEVIATIONS FROM RFQ VOLUMES

*A measure of how much volumes fall short from RFQs
(all measurements in percentage of shortage)*



Tata Motors has a planning problem, looking at the huge gap between RFQ and actual volumes

Leading the problematic OEMs is Tata Motors. The company's Aria crossover managed to clock less than 6% of its targeted RFQ volumes in 2012-13 and dipped even further. EMMAAA forecasts only 1% volume realization on RFQ numbers in FY 2014.

Tata's flagship sedan, the Manza and its previous generation – Tata Indigo – together haven't fared any better. In 2012, the company realized only 6% of the RFQ volumes and those numbers have dipped further to a forecasted 2% in FY2013/14.

The same is the state for the Nano. During the first three quarters of FY 2013-14, Tata Nano's production volumes were just 7.5% of the project RFQ volume given to suppliers. For the last quarter of the year, EMMAAA expects channel stuffing with the new Tata Nano Twist but the production volumes would continue to remain below the 10% mark.

Similarly, Tata's people mover Grande falls short of its RFQ projections by 84%.

However, in contrast to Tata, the other local player Mahindra does reasonably well on the RFQ volume front. The company clocked 84% of the target RFQ volumes for the Quanto (despite poor market response). Mahindra's suppliers also benefit from never dying models like the Bolero and components that are shared across multiple models.

However, Mahindra has a problem with verito where volumes are almost 60% short of the RFQ projections. Maybe the Vibe hatchback variant may help.

Amongst the global OEMs, EMMAAA's surveyed suppliers were quite happy with Hyundai. The suppliers claimed that the Korean manufacturer is able to balance local and export volumes to ensure that they can stay close to RFQ volume projections. This also gives them an upper hand in negotiating component prices.

Hyundai targeted RFQ volumes of 225,000 units p.a. for the i10, 120,000 units for the i20 and 130,000 units for the Eon. While the i10 has been doing between 95-110% of RFQ volumes, i20 is also in the 95-105% range. It is just the Eon that falls short of projections, managing 77% of the RFQ volumes.

The same is the case for Maruti, though in this case, the exports aren't as significant and most of the volume management is done through domestic demand and platform sharing.

Meanwhile, General Motors too has a problem of meeting RFQ volumes on the Enjoy. EMMAAA estimates volumes to be about 70% short this financial year.

Devious Deviations – Impact on Price Negotiations

Packaging a full-blown feature list in a car at the price of a motorbike is the holy grail of product planning and purchasing departments. Having sufficiently large numbers brings in economies of scale and that drives down component prices. Hence volumes are the preferred bargaining chips of all OEMs.

Suppliers too want to grow and are likely to take interest in programs, which will guarantee healthy volumes throughout the program's lifecycle. So the negotiation isn't really as much about what a component would cost, but whose volume forecast is correct. OEMs want to inflate numbers to lock-in suppliers at lower prices and suppliers want to ensure healthy volumes to keep their plants running at near capacity levels and good margins so they can trim down the flab and lower prices when OEMs demand year-on-year price mark downs.

What that usually means is that price negotiations are often thrown out of the window as suppliers develop their own defenses against these 'imaginary' volumes.

For programs where suppliers aren't confident of OEM plans, they counter the hyperbolized RFQ projections by asking for full or part compensation for developing dies, tools and towards other development costs. In return they offer lower fixed unit costs.

However, when suppliers are confident that volume projections would meet real demand, they quote higher fixed unit prices by

offering to absorb the development costs. This helps the suppliers in maintaining healthy margins, which can slowly be shaved when value engineering and value addition teams start demanding lower prices.

Hence OEMs, which make poor RFQ projections, negotiate with their suppliers from a position of weakness. They are also compelled to 'accommodate' suppliers on newer programs to help them dislodge financial losses they might have suffered on the back of lower volumes.

As you may expect, component quality issues may easily creep in to this process, as OEMs cannot run a weeding out process on poor quality suppliers, compelled, as they are to keep the suppliers.

Impact of RFQ Deviations on Suppliers' Health

When the Tata Nano was conceived, early estimates indicated an eventual demand of a million units per year, including spectacular export numbers. In the domestic market, the ultra low cost car was supposed to cannibalize the two-wheeler industry. The Singur plant (and later Sanand) had an installed capacity of 250,000 units per annum, expandable to 350,000 in the first round. [one_third boxed="true"] **Volumes or Profits?** When suppliers plan capacity they need to decide between running multiple shifts (management issue), paying higher logistics cost (pinches them to ship by air) or running additional capacity with single shifts. Tight shift management leads to capacity constraints and is mostly a P & L / margin issue. On the other hand, adding fresh capacity means expanding the balance sheet and taking a capital risk. So most suppliers tend to live with lower profits but significant volumes to ensure they have enough demand to keep their lines running. [/one_third]

The RFQ volumes projected were so significant that suppliers were polarized between two groups. There were those who

believed in Nano's potential and offered to setup dedicated plants and prices with wafer thin margins to get in early on this 'high-potential' program. Yet there were those who found little merit in the volume claims and chose to pass up the opportunity.

When the bookings window opened, barring the initial rush of early adopters, the demand for the Nano soon faltered and with it the fate of those OEMs who were locked-in at lower prices.

EMMAA projects Nano to manage just 10% of its projected volume in financial year 2013-14. Since several suppliers had setup dedicated plants for the Nano, low capacity utilization levels at their units mean that their investment recovery cycle is now extended much further down the road than what had planned initially.

Future Relevance on OEM-Supplier Relationships

The increasing number of vehicles in the market makes it difficult to estimate what real volumes would like. In cluttered segments, suppliers are now betting on platforms and OEMs instead of betting on programs. This helps suppliers in offering competitive prices while managing healthy volumes to run their plants. Consequently, well performing OEMs like Maruti and Hyundai get better prices while beleaguered OEMs like Tata Motors, Fiat and General Motors are pressed by suppliers to offer the tool and die costs in-part or in-full before the launch of the program. OEMs with solid export volumes also get healthy prices since they are capable of pushing their products to several markets outside India.