Attracted by explosive economic growth in South America, original equipment manufacturers from around the globe have stepped up their investment and operations in the region. As OEMs expand their footprint into South America’s rural areas, they’re inventing new ways to address their most pressing challenge: building a supplier network that can deliver the same value the OEMs enjoy in other parts of the world.
Oliver Wyman has long studied automotive original equipment manufacturers (OEMs) in regions around the world—from GM and Ford in North America, to PSA and Volkswagen in South America, to Audi and BMW in Europe, to Hyundai in Asia. But since 2005, it’s South America—particularly Brazil and Argentina—that has boasted the strongest growth of any of the regions we’ve looked at. Combined sales for OEM operations in these two nations showed double-digit volume increases during 2005-2010, jumping from 2.1 million units to 5.2 million. And their compound annual growth rate (CAGR) has hit 20%. Though Asia, at a CAGR of 18%, isn’t far behind, South American OEMs have left North America (at –7% CAGR) and Europe (just 2% CAGR) decidedly in the dust. Explosive population growth and seemingly limitless market upside continue to garner the greatest attention in Asia, but a growing middle and upper class in Brazil and Argentina has drawn the focus of OEMs around the world.

The industry’s remarkable growth in this region stems from newly available credit that the growing middle class is quickly putting to use. Moreover, an influx of foreign investment on the assurance of recent macroeconomic stability as well as a rich diversity of natural resources is driving unprecedented purchasing power in the region. The wave of OEM investment in new manufacturing facilities is simultaneously creating and capitalizing on growing demand. Following the global economic crisis of 2008, companies are taking advantage of newly found liquidity to enlarge their manufacturing footprint in South America’s Mercosur region (including modernizing older plants, building additional ones, and increasing plant capacity and output). Some are establishing a footprint for the first time (See Exhibit 1). Manufacturers that continue to pursue the antiquated model of hand-me-down equipment and past-generation vehicles for their South American operations will quickly be left behind. Consider these examples of new manufacturing initiatives in the region:

- The “One Ford” global strategy is apparent in the recent launch of the new Fiesta model at Camarçari.
- Fiat intends to build a new plant in Pernambuco, on Brazil’s eastern coast, capable of producing 150,000 low-cost vehicles for the local market.
- GM has made South America its fourth regional business unit and has set out to invest heavily over the next few years to renovate vehicle models and beef up capacity. The launch schedule is particularly aggressive at Sao Caetano, where GM has added new versions of the Montana, Corsa Classic, Cruze, and Cobalt models in under two years.
- China’s Chery is building its first South American plant. Slated for Brazil, the plant is expected to start producing low-cost vehicles by 2014.
CALLING ALL LOCAL SUPPLIERS

In Brazil and Argentina (the two largest Mercosur member countries), state and local governments have lured foreign investors by providing auto manufacturing and other industries with a variety of incentives. As local governments compete for new projects with offers of cheap or free land, tax incentives, government-funded education programs, and promises of infrastructural investment, OEMs have expanded their manufacturing footprint beyond traditional manufacturing zones in search of the best possible offering.
And as vehicle manufacturers establish operations in increasingly remote locations, they’re counting on their suppliers to provide the same value delivered in other regions—whether that value consists of modules such as instrument panels, doors, and bumpers; logistics services like warehousing and kitting; or general and preventive maintenance services. However, constrained infrastructure in these countries’ rural areas (for example, heavy congestion on Brazil’s relatively few paved roads) can imperil on-time delivery.

In a world of just-in-time manufacturing, this presents a significant challenge to manufacturers who set up shop in more out-of-the-way locations. Rural areas seeing expanded OEM footprints have historically lacked an existing local supply base. To ensure that their rising expectations will be met, manufacturers have sought to draw their supplier base to them—for example, by using suppliers located on-site or in nearby supplier parks. In South America, for example, 17% of major modules are assembled in supplier parks within minutes of the vehicle assembly site. Take Ford’s operation in Camaçari, on Brazil’s east coast, a region that had no history of auto manufacturing. Ford arranged for 26 suppliers to establish operations in and around its manufacturing site, promising them a larger share of vehicle work content as incentive.

Protectionist policies in Brazil and Argentina are giving local suppliers further competitive advantage in the region over suppliers located abroad. For instance, import tariffs on passenger cars are 35% in Brazil and 21.5% in Argentina; for auto parts, the tariffs are 16.5% and 17.5%, respectively. And thanks to local content requirements, as much as 30-60% of a vehicle’s components must be sourced from within the South American country stipulating the requirements. This becomes a major challenge if a high-cost component is sourced from abroad. To illustrate, a manufacturer choosing to source an engine and transmission from overseas could run through the majority of its foreign-content allotment from only two components. (Powertrain components can constitute more than 20% of total vehicle cost.) Though the current value of the Brazilian real has offset some cost barriers for importers, the net impact still favors sourcing of local content.

THE CONSUMER’S ROLE IN SUPPLIER LOCALIZATION

In addition to governments, consumers have played a role in heightening South American OEMs’ need for a local supply base. Like members of the expanding middle classes in other regions around the world, up-and-coming South Americans want modern, high-quality products tailored to their lifestyles. And they want them available when and where it’s most convenient for them.

As these consumers have pushed for such offerings, auto makers have increasingly relied on their suppliers for on-time delivery of high-quality parts, especially for new-product launches. Capable suppliers are critical to these companies’ success. Indeed, a disappointing product launch can often be attributed to a weak supplier network. But establishing a strong network to support a new offering developed in South America can be challenging, because (unlike in previous times) the manufacturing process hasn’t been tested and proven first at overseas facilities.
LEAN IMPLEMENTATION AND OEM SUPPLIERS

Lean implementation methods among South America-based auto OEMs will further influence how localization of their supplier base evolves. Some auto OEMs in South America are still in the early stages of lean implementation; for example, defining the vision and values behind effective lean systems and building basic lean disciplines such as 5S and visual management. Others perform at benchmark levels; for instance, establishing quality circles, flexible workforces, and continuous-improvement processes. These exemplars of lean production are also collaborating with suppliers to ensure that they meet the same high standards on cost, quality, and productivity metrics. Such manufacturers tend to maintain integrated supplier relationships—pushing lean learning across their industry’s value chain.

Suppliers developing their own lean systems will be better prepared to serve OEM customers across the full spectrum of lean maturity. Indeed, the degree of lean implementation will play a major role in OEMs’ expectations of their suppliers. This is particularly challenging because inter- and intraregional differences in lean maturity mean that suppliers may not be serving a uniform customer across the operations of a single OEM. To illustrate, older OEM facilities in traditional manufacturing zones might differ dramatically from more recently developed sites. One can see this variability in the wide range of labor productivity as measured by The Harbour Report™. Within South America alone, labor productivity can range from 20 to more than 50 labor hours per unit produced. With this in mind, the most progressive OEMs are executing four strategies to improve labor productivity:

1. Focus on in-process quality by reducing labor and time devoted to inspection and repair.
2. Increase collaboration between manufacturing and product development and engineering to design for manufacturability and to drive out complexity and variation.
3. In the tradition of the Toyota Production System, develop standardized manufacturing systems with flexible work teams trained to continuously improve processes. Flexible teams and uniform processes enable the best OEMs to balance complexity and vehicle variations across multiple work cells and quickly adjust to changes in demand.
4. Strike a balance between labor and automation that’s appropriate for the labor costs and technology in a given region. For instance, automate processes critical for quality and ergonomics, but keep processes manual as needed to maintain flexibility. Automate more if labor costs rise, but not to the extent that flexibility is eroded or capital requirements become too high.

TO IN-SOURCE OR OUTSOURCE?

As conditions continue to evolve in the South American auto manufacturing industry, OEMs will have to carefully consider their in-sourcing/out sourcing balance. The biggest motivators behind a preference for in-sourcing include labor costs, the desire to improve productivity, and quality concerns. In choosing to outsource, cost is still king, though OEMs now also expect their suppliers to add value while reducing cost. Suppliers are no longer treated as plug-and-play options and should strive to become an integrated part of OEMs’ lean manufacturing system.
An OEM may decide to outsource more when it lacks capacity, when suppliers are in convenient locations and have the required capabilities, and when the OEM wants to optimize its main-line workforce. In some cases, OEM and supplier integration reaches such levels that suppliers working within an OEM facility might be virtually indistinguishable from the core OEM operation. It’s become more common than ever for suppliers to provide logistics and maintenance support, module subassembly, and even main-line assembly within the four walls of their client’s plant.

Labor regulation also informs such decisions. While auto-manufacturing unions have ceded some control in North America, unions still constitute a major force in Argentina and Brazil. And while uncompetitive wage rates in North America led to outsourcing, the opposite is true in South America. Labor contracts at many South American manufacturing facilities dictate that OEMs must bring in new workers even when workforce reductions occur naturally through attrition. Moreover, OEMs believe that labor freed through productivity improvements can be redeployed within a plant. Thus more OEMs in South America are self-funding in-plant initiatives (such as in-sourcing module assembly or support services) with such freed-up labor. In some cases, suppliers looking for additional work must compete with a paid-for workforce already trained in the OEM’s manufacturing techniques.

Nevertheless, as South American plants invest in new vehicle programs and equipment, some consolidation of in-house manufactured content will likely occur as these companies migrate to global parts standards. To illustrate, most manufacturers around the world have reduced the level of vertical integration in their press shops by outsourcing everything but the major surface panels of the vehicle. This could open the door for suppliers to pick up more work that was previously in-sourced. Suppliers with existing manufacturing sites can take advantage of the opportunities that arise when OEMs lack needed capital and capacity to build in-house. And those within a few miles of an OEM customer have the biggest advantage, because most OEMs aren’t willing to source components that must arrive just in time or just in sequence beyond a specific distance.

Service providers may find opportunities to work with OEMs seeking to optimize their main-line workforce to increase output. As manufacturers strive to increase line speed, they must increase the ratio of value-added versus non-value-added work at each station. Logistics solutions that improve main-line optimization are particularly important in the post-downturn era, when OEMs are still leery of capital expansion unless absolutely necessary. Providers of logistics solutions can help manufacturers lower walk and pick time (for example, by offering kitting and sequencing services) so operators can enhance line speed. OEMs that have begun producing multiple vehicle models in one facility may find sophisticated logistics solutions even more attractive.
To make these relationships work, suppliers must understand and be privy to an OEM’s core-parts strategy and integrate themselves into its manufacturing system. When they work with best-in-class OEM customers, their own costs decrease as the benefits of lean manufacturing are pushed upstream in the industry’s value chain.

A number of powerful forces are driving localization of automotive OEM suppliers in South America. As the auto manufacturing landscape continues to shift in the region, OEMs and their suppliers are finding new ways to structure their working relationship so that, together, they can serve customers’ ever-increasing demand for quality vehicles. In this brave new world, OEMs and suppliers that partner in innovative ways will be those most likely to pull ahead of rivals—and stay there.
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