



Manufacturing in Europe: Changes, Challenges and Opportunities

By William G. Diehl and Arthur Nelson, excerpted from Financier Worldwide

Some challenging years lie ahead for the Western European manufacturing sector. On one side, it is faced with increasing competition from Asia and India, both of which are starting to offer lower costs and higher quality products by utilizing the competitive edge gained with access to new technologies. On the other side, new member states Central and Eastern Europe continue to gain strength and threaten established, neighboring markets. Despite the challenges, a revival of Western Europe's flagging manufacturing sector is possible, provided companies change their culture and focus on a simple, although seemingly complex, paradigm of adaptability.

Negative Market Forces

The European manufacturing market is experiencing trends similar to those in North America, where companies are battling against spiraling costs and depleted revenues. Competition from countries utilizing cheap labor and other peripheral cost reductions (such as logistics and direct access to natural resources), is making life difficult for mature European manufacturers.

Changing Old Habits

So what can European manufacturers do to survive in this untenable climate? The first step is to emerge from the current state of denial. A vast majority of European manufacturing companies are presently ignoring their problems. Change is unpopular, but that is precisely what rising

competition and plummeting prices will introduce to the sector. Expect changes to jobs, salaries, benefits, standards of living, the economy, government policies, and the way manufacturers conduct business.

Survival in the manufacturing sector will require a dramatic shift in attitude. If companies are to compete in the global manufacturing arena, there must be a concerted drive toward price reduction and a focus on best practices to minimize overhead and maximize profit.

Mature manufacturing companies are refining their supply chains and adapting their procurement operations, but this is not enough. Consideration must also be given to the manufacturing process. Companies must re-think the types and diversity of products they manufacture.

In the automotive sector, companies need to address operational constraints by introducing automated systems, where possible, to eliminate labor costs. MG Rover's historical reluctance to do so set them on the path to extinction several times before being rescued from the brink. But potential saviors—both rival automotive companies and discerning private equity players—finally lost their appetite and administrators sold the bulk of Rover's assets to a Chinese automotive company in July 2005.

The Rover case presents a textbook example of how poor communication can destroy a program of change. Senior management wanted to improve their company's

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ANNOUNCEMENTS

BBK is proud to announce the following team additions:

FINANCE

Gary Kulesza, Managing Director

OPERATIONS

Richard Anderson, Manager

James Feldkamp, Director

Steve Gordon, Manager

Frank Hatton, Consultant

Igor Hilden, Manager

Jim Leveleit, Manager

ADMINISTRATIVE

Tera Fisher, Assistant Controller

Jennifer Vukorpa, Executive Assistant

Our Chicago office has moved to 200 West Madison, Suite 750, Chicago, IL 60606.

BBK is a proud supporter of the American Red Cross Disaster Relief Fund for Hurricane Katrina victims. Over \$50,000 was raised, with combined donations from team members, BBK, and The Bahadur Family Foundation.

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CASE STUDY:

Fool Me Once, Shame on You. Fool Me Twice, Shame on Me.

Many companies have learned the hard way when it comes to how the financial distress of a vendor or customer can negatively impact their businesses. As a result, they are turning to customer and supply chain risk assessments. What do these avenues offer? The opportunity to maintain production and subsequent revenue stream for starters. Checking credit reports can help, but without a comprehensive approach to risk management, a company can literally be risking everything. OEMs, suppliers and lenders continue to explore more proactive ways to identify and predict the likelihood for financial distress and make comprehensive risk management a permanent part of their vendor selection and review process.

BBK recently completed the first phase of a broad-based BBK Ratings engagement for a Tier 1 supplier, which requires all of its suppliers to receive a BBK Rating on a semiannual basis. (BBK Ratings predicts the likelihood that a company will experience

Our client could rest easy knowing that 80% of its supply base fell into the A or B Rating category.

financial distress by accurately reviewing key financial data. For more information visit www.bbkratings.com.) Collecting financial data, generating reports and supplying supporting data for a large supply base is no small undertaking. Here's how our team of experts got it done.

Initially, we partnered with our client to collect addresses and contact data for all of their suppliers. Privacy notices were generated both by BBK and our client to ensure confidential transfer of information. Letters went out to each supplier to explain the process and intent. Forms required for collecting financial data, as well as directions for electronic submission, were also included in the packet. BBK coordinated the production, assembly, and distribution of all packets to suppliers on behalf of our client.

Different challenges arise when collecting financial data. Suppliers are certainly concerned about customers seeing their profit margin as it gives them leverage to come back and request a lower price. Knowing that this information is being discretely handled by a reputable third party simplifies compliance so results can be provided quickly, and the supplier knows that their data will not be used against them in negotiations.



How Secure is Your Supply Chain?

BBK had a team of experts collect and analyze the data submitted and reports were generated. The results? Our client could rest easy knowing that 80% of its supply base fell into the A or B Rating category. Transactions with those suppliers remained constant following our assessment. Twenty percent of the supply base, however, was in the C, D or F category, which indicated that further analysis was needed to determine viability. To address this 20%, BBK worked with the Tier 1 to perform due diligence on each company, which resulted in suppliers being put on a watch list or replaced.

The “eyes wide open” approach that this company took in regard to its supply base, enabled them to take proactive steps to protect a pending product launch and avoid a costly production line interruption.

Our client also found that the Ratings process opened more doors with their suppliers, a significant value-add. Initially, there were a handful of suppliers that were unwilling to release their financial data. In many instances, however, they did allow either BBK staff or staff from our client to visit their offices and review the books—a gesture to offer peace of mind.

Is a comprehensive Ratings program the right solution for every company's risk management initiative? Not necessarily. While individual Ratings on questionable companies are within anyone's scope, the success of a large-scale implementation can be subject to the market power held by the OEM or Tier 1.

The lesson learned is to keep your eyes open and be proactive about managing risk in your supply base. A familiar adage holds true, fool me once, shame on you-fool me twice, shame on me. ■

For more information on BBK Ratings, contact Alicia Masse at 248.603.6435 or amasse@e-bbk.com



Q&A WITH BBK PRINCIPAL BEN GOREN

Private Equity Due Diligence

When is it “enough” with due diligence?

With returns to PE funds and hedge funds shrinking, the dealmakers need to look under as many rocks as possible. It is not enough to just get an accounting firm to audit historical financials and test projections. It has become extraordinarily important to look at a potential acquisition’s operations, business strategy, culture (existing and integrated), risk profile, and true prospects before taking the plunge. Of course, this does not lessen the importance of financial due diligence but merely demonstrates that in today’s hyper-competitive world, purchasers need to be more careful in their assessments of a target’s finances, strategy, operation, and culture.

How can you perform due diligence on business strategy?

Experts, experts, experts! Many people who are running PE and/or hedge funds tend to lean towards large, pedigree consulting firms. However, this is not always the surest path to success, as nobody can be a true expert across an infinite number of businesses, especially when they are working on three to five deals at the same time. Instead, buyers should be highly encouraged to seek out former senior managers to perform the due diligence. Their deep expertise and real-world experience can help even the most successful deal makers more quickly understand a firm’s go-to-market approach and help confirm/deny prospects, competition and overall strategy.

How do you investigate a target’s financial plan prior to either making an offer or closing a transaction?

Is it enough to just discount a hockey stick? Most buyers today will utilize a large accounting firm to assist with

financial due diligence. This is a great first step, but it is simply not enough for most deals today. Even the most sophisticated buyers and their due diligence providers can miss very important things or be led astray by insiders. The obvious examples of this today are the Refco transactions. Potential buyers need to be able to “check” themselves at the door when they start requesting financial plans even before an LOI. If a target does not want to cooperate or cooperate enough, be ready to walk and let some other firm “have” the deal. When you or your advisor get a financial plan, go line by line and test not just the numbers but also the reality behind each line. Take the time to share the financial plan with all of your due diligence advisors to make sure the various aspects make sense and can work in unison in their “real world”. Also, check your due diligence providers. The best advice I have ever given a client is to walk away from a deal. However, make sure that your advisors are neither “forcing” you into a deal, nor discounting things so much that their pessimism gets in the way of the right transaction.

How do you investigate a firm’s operations?

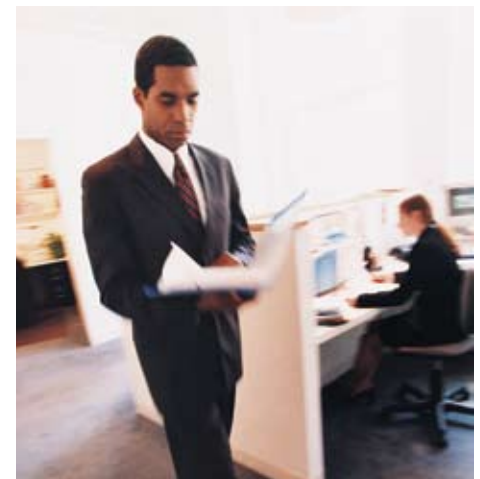
In many transactions, operations is the first area to find those often elusive synergies. It is better to know what you are going to get on the operations side before you walk in as an owner and ask: How does this work? Regardless of if you are buying a financial services firm or a widget manufacturer, solid operations is a key to success. Hire someone who “knows better” and can roll up their sleeves and take a hands-on approach. Make sure that the operations review is conducted by people who can speak the language and will gain the respect of those on the shop floor. Have someone investigate how throughput comes in and gets out the door. How is the

target’s operation aligned? If your target is a manufacturer, how lean are their operations currently and how open is the management team to change? Make sure to take the operational issues all the way out to the target’s customers. What is the impression of quality to the customers and/or clients? Are operations timely from the customer/client perspective? Always, always make sure that a target’s operations do or can match up with the target’s strategic and financial plans. The co-dependency of due diligence also illustrates the point that the best due diligence providers are deeply experienced, understand the merger and acquisition world, can work well with other professionals, and are trustworthy with solid reputations.

How does corporate culture play into a transaction and what can one do to diligence corporate culture?

Too many dealmakers are dismissive of corporate culture as an important aspect of any transaction. People will often suggest that “the worker bees will just make the widget,” but that is not a reality-based statement. It is imperative for an acquirer to dig deeply into the culture of a firm to really assess its prospects or potential to integrate with another firm

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SPECIAL EVENTS

Economic and Commercial Development in China

On September 29, 2005, the BBK Program on Global Economics and Commerce opened its 2005-2006 lecture series with a presentation by former Congressman Michael Kopetski, "Economic and Commercial Development in China." The program was presented at the Troy Marriott Hotel following introductory remarks by Dr. Fred Pearson, Executive Director of the Detroit Council of World Affairs, and retired U.S. Bankruptcy Judge, Ray Reynolds Graves, BBK Principal.

Mr. Kopetski took his audience through a brief and engaging history of the development of modern China. As a consultant for businesses looking to expand opportunities in China, the former congressman was able to give new insights on the often complicated negotiations between China and the U.S. He specifically addressed those involving the manufacturing and export of computer parts, pirated software, automobiles and agricultural products. Kopetski reminded his audience that businesses in Asia will continue to move jobs to low wage labor markets and as China's industrial workers become middle class, they will see a portion of jobs moved to Vietnam or Indonesia.

In a lively question and answer session after his presentation, Kopetski warned that the growth and development of the Chinese automobile industry in the Twenty-first Century



From Left to Right, Ray Reynolds Graves, BBK Principal; Congressman Michael Kopetski; and Fred Pearson, Director, Detroit Council for World Affairs

could pose the same threat to market share that the U.S. faced from Japan in the second half of the Twentieth Century. China's rapid industrialization is beginning to draw on the world's diminishing energy resources and the country is slowly recognizing the environmental hazards created by manufacturing.

The second installment of BBK's Program on Global Economics and Commerce will be held in March and will focus on another area of commerce and manufacturing in the global economy. ■

For more information, please contact marketing@e-bbk.com

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Manufacturing in Europe

quality and productivity by implementing automation and outsourcing measures to reduce labor costs. Unfortunately, resistance from unions and other work groups accelerated the company's demise. Prior to any operational upheaval, senior management and union representatives need to sit around the table and work with each other. To the workforce, fear of the unknown is often worse than the restructuring plan itself. Employees usually neglect the big picture and believe management is simply perpetrating job cuts. In fact, management is usually attempting to preserve the majority of jobs by sacrificing a minority of them, and this needs to be communicated to the workforce to avoid negative opinion, which can be fatal in a turnaround situation.

The Importance Of Acting Now

So where does responsibility for change lie? There have been calls for the European Union to reform the punitive legacies of its 'pro-employee' legal regime. EU countries may have to reconsider their policies governing working hours, holidays, pensions and benefits. This action is highly unfavorable from a political standpoint. Telling the workforce it needs to radically increase its working hours and raise its productivity rate is sure to prompt a backlash. Politicians and bureaucrats have taken years to implement legislation that protects the rights of employees, so who will lobby for its reversal?

Responsibility lies with companies themselves. It is becoming extremely difficult for them to compete on price, particularly with companies that manufacture small components that can be easily shipped around the world and are not dependant on short lead times. Low-tech assemblies and mass-produced commodities are almost impossible to undercut. If they are to survive—and indeed thrive—in this highly competitive marketplace, manufacturers must utilize their expertise and hone it to their advantage.

Manufacturers need to focus on improving throughput and reducing inventories by manufacturing-to-order rather than stockpiling, especially in sectors affected by cyclical demand. European manufacturers also need to strive for zero-defect manufacturing to retain their global reputation for quality. A commitment to continuous improvement in this field is imperative. Further, they must automate a high proportion of their labor-intensive manual operations to reduce the monthly wage bill. A concerted drive should be made to upgrade or replace underperforming equipment and plants. Low-tech components and commodities should be outsourced to manufacturers in low cost countries.

Change in the manufacturing sector will not be driven by a major leap forward. Gradual progression is far more likely, and companies cannot wait. They must look at their own businesses and begin to make changes that can give them a competitive advantage in the future. The sooner these companies adapt to today's global manufacturing market, the better for countries with mature economies. ■

For the full article, contact marketing@e-bbk.com



LETTER FROM BBK

A Time for Change

The City of Detroit just hosted its 18th year of the North American International Auto Show. Detroit joins Frankfurt, Geneva, Paris and Tokyo as being ranked among the premier international auto shows in the world.

Prior to becoming an international show, the Detroit Auto Dealers Association sponsored its first event in 1907, where 17 exhibitors displayed 33 vehicles. Nearly 100 years later, the show welcomed over 73 exhibitors, 68 new vehicles and more than 1 million square feet of exhibits.

Like the auto show, the North American auto industry has undergone significant change. Over the past 100 years, the industry has grown up and matured, as evidenced by intense competition, a deep manufacturing base, extensive distribution channels, and broad manufacturing and engineering expertise. It has been a tough road for domestic original equipment manufacturers (OEMs) and suppliers alike, and the road is likely to get even tougher before it gets better.

Yet in spite of the many changes and challenges this historically rich and innovative industry currently faces, roughly 800,000 people visited the Motor City to “drive their senses wild” and revel in the exhilaration of the auto show. Many consumers, investors and those “in the biz” were eager to check out the dizzying array of vehicles touting new options, colors, and designs. Indeed,

the auto show delivered a welcome—albeit brief—distraction to what has become one of the most difficult periods the automotive industry has faced.

The exciting vehicle advancements also reflect this resilient industry’s

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ability to change, adapt and survive. Even after a tumultuous year in 2005, with unprecedented bankruptcy filings of mega-suppliers and extreme cost structure challenges for OEMs, innovation and great technological advances still prevail.

So along with the historic auto show, which continues its evolution, the North American automotive industry will continue to undergo change and restructure. Will the road ahead be easy? No, it won’t. In fact, everyone involved knows that several phases of the industry restructuring will be tough to deal with as the issues are complex and require compromise. Some things may be eliminated out of necessity—this includes companies and long-standing tenets of the industry. However, once repaired, the North American Automotive Industry will be poised for a healthy and sustainable future, with no end to the show that praises its glory in sight.

Alicia Masse
Principal

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Private Equity Due Diligence

and to understand the desires of new equity holders. Make sure to start the analysis at the top and go all the way down to the bottom. All the clichés are true—you are only as good as the weakest link—find out what drives management, as well as what drives those who work the lines. Further, if you, as the buyer, are planning to make significant changes, such as hiring, firing, launching new product lines, integrating with another company etc., you should conduct due diligence to help you understand and best anticipate the potential impact of those changes. Dive deep into the leadership of the firm as well as the firm’s history. Explore the alliances, loyalties and friendships, the decision-making process, and the overall nature of the firm.

How can failure to perform this diligence affect your transaction? Take the NationsBank/Montgomery merger. Within about three years’ time of the deal, most of the Montgomery contracts had expired, and there was not a handful of former Montgomery employees to be found within NationsBank. Was it Nations’ fault, Montgomery’s fault, or was it just that this was never the right cultural fit? ■

Ben Goren, BBK Principal based in Chicago, is a frequent speaker on due diligence and M&A advisory. Ben can be reached at 312.795.1595 or bgoren@e-bbk.com

INTERNATIONAL OFFICE

BBK Sets Up Shop in Shanghai

BBK is proud to announce the opening of its newest office in Shanghai, China. Our expansion into Asia—on the heels of our European office openings in Frankfurt and Warsaw—strengthens our position to deliver the financial, strategic and operational expertise that we are known for on a global platform.

James Feldkamp, Director, will be based in Shanghai. James joins BBK with over 10 years of experience as an operations and finance professional working in Asia or with Asia-based companies. Most recently, James was the Manager of Aftermarket Marketing for Carrier Corporation-United Technologies (the world's largest air conditioning and refrigeration corporation), covering the China Region. In this position, he developed and initiated implementation of a strategic five-year business plan to grow Carrier's aftermarket revenues in China ten-fold by 2010.

Prior to this position, James was the Manager of Asia Pacific Business Development for Carrier Corporation. In this role, he acted as lead Carrier representative in the three-way JV negotiation with Midea (China's largest air conditioning company), led the Asia Pacific team for integration of Linde, a \$1B global refrigeration company acquired by Carrier, and developed an Asia-wide merger and acquisition strategy, including identification and prioritization of targets. Prior to his work with Carrier Corporation, James was Founder & Managing Partner at Pacific Link Consulting, LLC, where he advised multinational clients on issues of strategy and operations in China.

James holds an MBA in International Business from INSEAD, Singapore & Fontainebleau, France, and he holds two Bachelor of Science degrees, one in Transportation Systems and another in Entrepreneurial Management, from The Wharton School, University of Pennsylvania. In addition, he speaks and writes Mandarin Chinese as well as French. ■

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