

Supplier profile: Tenneco

The North American supplier is one of the few companies to have seen positive results in the recent downturn. But where do the future challenges lie?

IN the rollercoaster ride experienced by most automotive sector companies in the last year or so, few seem to be coping as well as emission and ride control specialists Tenneco, who have just reported a much-better-than-expected set of second-quarter results.

By spotting the situation early and aggressively reducing costs, without endangering the company's core R&D and engineering functions, Tenneco are now well-placed to expand into new markets, gain share in existing markets and further develop their technical credibility and expertise in the next few years. This has resulted in a 10 fold increase Tenneco's share price in the last four months, despite a drop in revenue of one third.

A recent visit by *SupplierBusiness* to Tenneco's European R&D and Engineering centre in Edenkoben, Germany confirmed that despite their vigorous cost-cutting programs, Tenneco maintains a focus on staying ahead in the race to find solutions to the problem posed by increasingly stringent global emissions regulation.

Wolfgang Reuter, Vice President Sales and Engineering, Emission Control International was asked about the impact of reduced revenues, tighter margins and cost-cutting on the company's ability to sustain expenditure on R&D and engineering: "You're quite right, we are under considerable pressure in this area. So what we must do is to lean out our engineering organisation as much as we can. And that's one thing that we're doing. We're leaning out our processes. We using more and more sophisticated tools to help us with the design process and shorten the lead time per design. Plus we have a big effort moving into low-cost countries for engineering. For example, we have set up a completely new engineering centre in Rybnik, Poland, and we have also been increasing our in-house engineering resources in India. In addition, we are outsourcing certain work packages to engineering firms in India. For example, system simulation activities."

As the success of their cost-cutting shows, these strategies seem to be working for Tenneco. But not all costs are associated with in-house activities. The OEMs themselves are under great financial pressure and this is being passed on to their suppliers as they demand more for less.

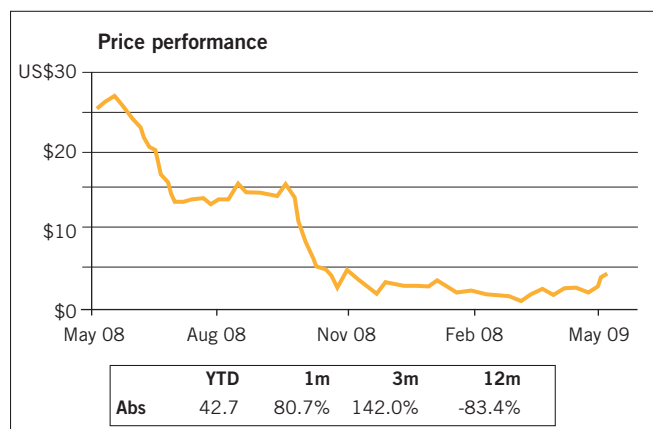
For example, specialist suppliers such as Tenneco are being asked increasingly to bear the development cost of new technology and this is affecting the kind of deal that the suppliers are making with their customers.

Wolfgang Reuter again: "It is a fact that we now have to do much more upfront work before we are nominated for a piece of business. We have a lot of what they call 'concept competition'. It is almost like architects, where you have to have to develop a concept, the design. Then they evaluate it, and based on their evaluation, they nominate the serial supplier."

And of course in competitive situations, the OEMs are picking the best offers from each bidder and making these the target for each element of the contract, raising the bar for everyone.

Josep Fornos, Tenneco's Vice President & General Manager, Emission Control Europe comments on the supplier selection process: "What they measure is the full value package, not just the price. And this is all taken into account in the Terms and Conditions: advance or progressive payments on tooling or R&D and so on. And of course they want to get the best of everything.

"They say: 'OK, this is offering me the best deal on R&D, so that will be my R&D target. This one is offering you the best deal on price, so that will be my price target.' It becomes a case-by-



case negotiation. In the end, the OEM looks at the whole thing and makes a decision based on the complete value package.”

As well as negotiating the changes in their cost base, Tenneco is also facing some changes in the market from the vision they had a little more than a year ago.

At the Frankfurt IAA show in late 2007, Tenneco's Chief Technology Officer, Tim Jackson, said that the company was projecting a 3% to 15% increase in diesel powered passenger cars in the United States 2012, and that this would drive their market in North America. The situation has now changed, as was confirmed by a senior executive of Tenneco in early August 2009:

“We've now got some fresh statistics on this that say it will more likely grow to 5%. So that's the order of magnitude of the change in just a few months. The whole diesel story in North America has changed dramatically. The only ones pushing it still, with a high degree of optimism, are the German OEMs; Volkswagen, Mercedes, Audi. Also BMW, but not as aggressively. VW Group and Daimler are the ones that are pushing it the hardest. And by the way, many OEMs have cancelled diesel programs.”

One view as to why this change has occurred is that the market is just retrenching back to what it knows. Do Tenneco agree? Our executive thinks that this may partly be the case.

“... and also the economics just don't justify it now. There's a huge premium for diesel cars – US\$4000. If you look at the economics, there is now no decent payback, not at the current price of gasoline in North America. In fact, for quite some time, diesel was even more expensive than gasoline. In my opinion, Europe drives diesel demand through taxation. It's all driven through how gasoline and diesel are taxed and how ultimately the consumers pay; and in North America there is no such policy on diesel.”

But what about the trend towards smaller vehicles in the United States? Tenneco executives think that the pendulum has swung too far away from SUVs and pickup trucks towards smaller cars, and that process has now come to an end. SUV penetration is coming back in the form of crossover vehicles, not perhaps quite up to historical levels but still returning, so the downsizing trend in North America will slow and the product mix will move back towards a more traditional shape. In their view: “The CUV is the new hot segment. SUV's will probably never come back to what they were, but nevertheless the collapse has ended.”

This situation is interesting when considering Tenneco's future.

They are fairly well represented across the market spectrum, so there isn't a specific adverse effect on the company from this shift in the market back to larger vehicles. And because the company has a strong European operation, is well positioned to capitalise on the increased size of the market for smaller vehicles. This is because many of the smaller vehicles finding their way on to the North American market are based on European platforms are already supported by Tenneco. As a result, the company can transfer existing designs and technologies into those new vehicles, and perhaps gain market share.

So we can see that Tenneco has a good platform upon which to build its future growth: an effective approach to cost-cutting; an investment strategy for lower-cost locations which has been re-timed rather than scrapped; and a body of expertise in the development of emission systems for smaller vehicles which they can bring into North America from Europe and apply globally. In this context, the recent soaring performance of their share price is easy to understand.

Exhaust after-treatment system suppliers and diversification

The recent crash in the world market passenger cars has caused many automotive suppliers to look carefully at alternatives to their traditional markets.

In the case of European emission systems manufacturers, one obvious target is the market for off-road vehicles. Agricultural and construction machinery is almost universally powered by diesel engines, and in common with passenger cars, emissions from these vehicles are being targeted by regulators. And as these businesses have expertise in diesel exhaust after-treatment, a good

opportunity exists for product diversification and expansion into new markets. Stricter emissions regulations for off-road vehicles come into force from 2011: Stage III B and IV in Europe; Tier 4i and Tier 4 in North America; and there are plans for a similar regulatory environment in Japan. So the opportunity is in the relatively near-term.

One recent tangible example of the attractiveness of this opportunity is the declaration of a joint-venture by Bosch, Deutz and Eberspächer, who intend to cooperate on the joint development, production and sale of diesel exhaust after-treatment systems for off-road applications. A memorandum of understanding supporting this venture was signed by the three companies in early August 2009.

Tenneco is another player in this market focusing on non-passenger car business.

Hari Nair, President of Tenneco's International business recently spoke to *SupplierBusiness* about this strategy: "We are building up our business in non-passenger car sectors, so that even if the passenger car market in Europe is flat in the next few years, from our point of view overall, the picture will still be positive. We are doing this by refining our product lines, and at the same time increasing our market share not only in light vehicles, but also in commercial vehicles and off-road vehicles."

Does that mean that Tenneco's focus or product mix in Europe is going to change?

Hari Nair again: "Light vehicles will still be the substantial portion of our business. So it's not that we are de-emphasising that – we are growing share in that market. What is changing dramatically, is that we're establishing a position in the off-road and commercial vehicles side of the business. So our growth rate in that sector is higher, because we're starting from a small base, but this will not be at the expense of light vehicles."

There are two factors driving this opportunity for emission systems companies.

Firstly, there is the effect of a growing market for mid-sized diesel engine off-road vehicles. For example, the fastest growing sector globally for Agricultural Tractors centres around the horsepower vehicles. This is because in some developing regions such as India, the landholding by individual farmers is beginning to increase at the same time as agricultural workers are being attracted to work in the construction and civil engineering projects in fast-developing urban commercial centres. This shortage of manpower is creating a growing market for agricultural machinery. And so-called hobby farmers in the west are also buying larger vehicles.

Secondly, as mentioned above, there is the fact that these vehicles will soon have to meet more stringent emissions norms and so will have to increase the content per vehicle in their exhaust after-treatment system. In order to meet this demand, OEM's will need expertise and companies like Tenneco are more than willing to sell it to them once they find they can't do it themselves.

Hari Nair has had experience of this: "Many manufacturers of off-road vehicles in the west have tried to design their own exhaust after-treatment systems, and have done a lot of work on it. But they have concluded – and one example is Caterpillar, one of the largest manufacturers of off-road vehicles and engines in the world – that it's better to go with an expert.

Last year we announced that Tenneco had become a global diesel emission control system integration supplier to Caterpillar Inc. In this role, Tenneco will work with Caterpillar to develop and produce diesel engine after treatment systems for Caterpillar engines. Looking further afield, as far as the Indian manufacturers are concerned, they are still looking at the advantages of external solutions, and let's face it they are not facing the same regulations – yet. But it's coming."

So from the point of view of these companies, there is both an immediate benefit in diversifying into off-road so that they can meet the demand for systems in their mature markets in Europe and North America. And then, as governments further east tighten their regulations, the market will develop there. This opportunity is too good to miss and so it is not surprising that diversification is the order of the day for exhaust and after treatment systems companies.

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Full interview on page 16



Hari Nair
Executive Vice
President
Tenneco

SUPPLYING DAIMLER

SUPPLIER STRATEGY:
TENNECOSUPPLIER STRATEGY:
TRUCKSJAPANESE SUPPLIERS:
TRW

ROUND-UP

QUESTIONS & ANSWERS Hari Nair, Executive Vice President, Tenneco

Hari Nair is Executive Vice President of Tenneco, President of the company's International Group, and a member of Tenneco's Board of Directors. He is responsible for managing all of Tenneco's businesses operations outside North America, which in 2008 accounted for 66% of the company's total revenues. Here, in an exclusive interview with SupplierBusiness, Hari Nair talks about the current situation in the industry, Tenneco's response, the market in the next few years and his company's plans.

Could we begin by talking about how the current crisis is affecting Tenneco and what your response to the situation has been?

Well, the situation has had the same impact upon us as it has on everybody. The market downturn is affecting the whole industry. So the important thing is how different companies have responded to the situation. Volumes are down this year compared with last year, and they're significantly lower than we expected at that time when we made our first forecasts. But I think that the response we have made in terms of cost cutting – in manufacturing areas, in back office areas, in cooperation with suppliers on the price of raw materials and so on – all this has made a real impact and is helping us to get through these difficult times.

Of course we are not unique in taking this approach, all the companies with whom we are constantly in touch through the VDA forum and other forums, all companies are doing very similar things. But I would say that perhaps we anticipated the situation a little bit more. And so we were more aggressive at the beginning than the others. We also put a strong emphasis on cash generation, so that we could secure our liquidity.

So how do you see things going forward?

All the industry forecasts point to a 2010 that will probably be relatively flat in Europe versus 2009 – at best. The theory now, coming up more and more, is that 2009 is artificially inflated, so 2010 is unlikely to grow. But for the rest of the world, it currently looks like it may be starting to recover. North America production could grow compared to Europe, particularly because they've had a massive inventory adjustment in the industry. China has never stopped growing, albeit at a lower rate. Based on current forecasts, I expect that most of Asia will grow; and South America will probably be relatively flat but they're still strong.

What about Europe looking out to, say, 2015?

Again, I can only base my predictions on what the industry forecasters say. If they are correct, we could see our volumes returning to peak 2007 levels by the mid-2012 to 2013 time period. By 2015 therefore, we could see a slight rise on 2012, but not that great. It might be 1% or 2%.

And Russia?

All the external data indicates that 2010 will be bad. Will it be worse than this year? That's a good question. It will probably not be a lot better. In 2008 versus 2007, Russia was 57% or 58% up in car sales. In 2009 versus 2008, it's 50% or 51% down! That's June year-to-date. At this rate, I think 2010 in Russia is likely to be very similar to 2009.

This is of course OEM business. How do you see the Aftermarket business moving?

Volumes have continued to decline. The official industry-wide measurement is roughly 8% to 10% per year. And this is almost entirely driven by materials changes which occurred, let's say, about 10 to 15 years ago. So whereas an old mild steel product would last maybe three years, now 7 to 10 years is not unusual. So you're talking about a completely different cycle entirely so that takes a whole chunk of demand out of the system. However, the systems are now a little more sophisticated than in the past. You have catalytic converters; and soon we will have the first tranche of diesel particulate filters that were OEM in 2001, and these will maybe coming forward as a replacement opportunity maybe in 2010. So there are offsets. But at the end of the day, the industry unit volume is declining. There is no other way to describe it.

So looking at your overall business and the margins you can achieve. There is now more content in after-treatment systems, but at the same time raw materials prices have been quite tough in the recent past. Are you finding that you're able to sustain your margins under these pressures?

The simple answer is yes. But obviously it's never that simple. Pricing is ultimately market-driven. But our market share, our distribution strengths and our product positioning – which is generally the best in class – these allow us to maintain our margins. And we are also putting in very hard work on the cost side. We have a culture of continually reviewing costs. It's a constant process. To give you a structural example of that, in years past we have dedicated aftermarket plants and dedicated OEM plants. Now, with one exception, they're all shared. So using the same plants to use OEM product and aftermarket product, obviously separately but sharing the infrastructure.

Raw materials are also an important cost component. How do you see raw materials prices moving in the next year or so?

Well, 2008 was a huge peak. But since, I would say, September or October 2008 it went down until, say, April. Since then it looks like going forward it may be going up with the potential of 2010 prices being back at the level of prices for March, April 2008. Which is still high but not the peak. In fact it's the point at which prices started growing very fast. Which is higher than it is today, but it's not the peak as it was in late 2008. This is primarily for stainless steel prices and we would expect the same kind of situation for the price of precious metals.

And do the OEMs just expect you to absorb those costs?

They try to defend their own interests. But they know it's not in their interests to really damage our business and so the endpoint has to be a balanced solution.

Finally, are you slowing down investments in central and eastern Europe because of the drop in the Russian market?

It definitely has an impact. Not changing the strategy, but either delaying the extension of existing plants or the building of new plants. For example, we have plans to open one more plant in Russia and extend the existing ones, we already have two plants there. But these plans have been postponed by two years.