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WHITE PAPER

February 2022

2022 & Beyond: Continued Challenges in the Automotive Supply Chain

A publication jointly authored by the lawyers of Jones Day, and Alvarez & Marsal.

While our inboxes are flooded on a daily basis with news about how the pandemic has created supply chain and commodities issues, global organizations must think about more than just near-term issues. Although the pandemic will recede, long-term factors like geo-politics, evolving governance standards, changes in regulations, environmental and tax laws, and implementation of new trade agreements will force a reorientation of global supply chains. Gone are the days where "lean" metrics were the sole drivers of supply chains, as a multitude of factors must be considered moving into the future.

Each supplier must determine how strategic each of its locations is to its future plans, and whether it is advantageous to exit a plant or geographic area with supply agreements as necessary to service legacy parts of the business. This White Paper discusses key issues that must be considered as global organizations consider reducing supply in certain countries or regions and ramping up capacity in other countries.

Even before the onset of the COVID-19 pandemic, geo-political tensions, electrification, and new climate mandates were already starting to affect the automotive supply base. While the trade wars and tariffs of the Trump Administration may prove transitory, electrification of powertrains, changes to original equipment manufacturer ("OEM") vehicle offerings and the pursuit of environmental, social, and governance ("ESG") targets will continue to have an enormous impact on manufacturing plants and supply chains, from OEMs down through the tier suppliers. As volumes of vehicles with internal combustion engines shrink, many suppliers are finding that their current manufacturing footprint may be a strategic disadvantage. Unfortunately, the shift to new vehicle technologies is occurring gradually over a period of time, forcing suppliers to find ways to adjust costs downward to service a shrinking legacy business, while at the same time requiring investments based on future product technologies and manufacturing locations of customers.

Each supplier must determine how strategic each of its locations are to its future plans, and whether it is advantageous to exit a plant or geographic area with supply agreements as necessary to service legacy parts of the business. Key issues must be considered as global organizations consider reducing supply in certain countries or regions and ramping up capacity in other countries.

Suppliers serving traditional OEM powertrain plants face some of the most significant changes through the 2020s, as electric vehicles ("EVs") may represent over 50% of new vehicle sales by 2030 and most OEMs have indicated they expect to phase out internal combustion engines sometime between 2030 and 2035. All suppliers, however, must revisit their manufacturing strategies and take into account a rapidly changing forecast for future product offerings, which will also be impacted heavily by future governmental policy goals and legislation.

CLIMATE INITIATIVES, ESG METRICS, AND SUPPLY BASE TRANSPARENCY AS PART OF THE NEW SUPPLY CHAIN RESILIENCY

Over the past few decades the automotive industry has prided itself on its "lean" supply chain with just-in-time manufacturing. While the concentration of semiconductor supply has received a substantial amount of attention, OEMs and suppliers have faced challenges across the board with material shortages and dramatically increasing prices. In addition, as the usage of certain commodities required in electric vehicles skyrockets, more attention is being given to sourcing strategies and methods used all the way down the supply chain to ensure consistency with ESG goals.

While the pandemic has exposed the need to reorient more resilient supply chains, new ESG monitoring is dissuading companies from merely targeting lowest costs in under-regulated countries. Faced with these new reporting requirements, procurement and supply chain teams are having to rapidly evolve beyond the traditional contract and performance management techniques such as those used for materials sourcing (Identity Preserved, Segregated, Mass Balance, Book and Claim). Combine this with the SEC pushing for increased disclosures around these items, and it is clear that automotive suppliers must consider the environmental and social impacts of their sourcing decisions. Unlike in the past, this monitoring is not limited to owned and controlled assets. Instead, reporting must look down into the sub-supplier base to look at impacts of the entire supply chain on required ESG goals.

Increased implementation of ESG goals and tracking at the OEM level will have an impact down the supply chain. OEMs have begun more detailed analyses of their supply chains all the way down to the lowest level, mapping out each component, part and wire entering into the assembly plants. Many large tier one suppliers have also begun this process and it is expected that suppliers that have their arms around this information will be in a better position to win work and take advantage of OEM targets for various initiatives that are taking center stage.

Transparency in the automotive supply chain is not an easy task. Many OEMs and suppliers operate in countries that do not require sophisticated record keeping and do not necessarily follow the same robust procurement processes that exist in more developed countries. As OEM product mix shifts dramatically and manufacturing centers evolve, tier one suppliers should utilize this time to revisit processes for evaluating their supply base, including establishing new processes for sub-tier supplier acceptance and metrics involved in the ongoing evaluation of a supplier's performance. As suppliers make sourcing decisions, required transparency and reporting ability must be taken into account.

Clear contract terms regarding transparency and reporting with OEM's and sub-suppliers will be key to navigating this increasingly complex environment.

LABOR ISSUES

Restructuring has long been a defining characteristic of the automotive industry. The global automotive industry faced significant labor challenges before the COVID-19 pandemic as a result of the pending transition to electrification. Now that EV manufacturing, which requires electric motors, e-axles, and power electronics as well as battery and charging technology, is kicking into high gear, OEMs and suppliers must restructure their manufacturing assets and supply chains to deliver these new products. This accelerating transformation will significantly impact automotive industry employment, given that EVs are quicker and easier to build than vehicles with combustion engines. OEMs and suppliers must retool their manufacturing assets and supply chains to deliver these new products and technologies. At the same time, the transition to EVs and autonomous vehicles ("AVs") will render significant parts of existing automotive supply chains redundant.

The ability of OEMs and suppliers to implement necessary changes in their manufacturing and distribution organizations will be significantly impacted by labor and employment laws and regulations in the myriad of jurisdictions where automotive parts are manufactured and vehicles are assembled. Most legal regimes impose substantial limitations on the ability of employers to close facilities and reduce employment levels. Further, employee representation regimes and collective bargaining obligations impose additional burdens on companies attempting to restructure their organizations. The ability to effectively navigate these legal regimes will be essential for the effective transformation of the automotive supply chain.

At the same time, capital investments in new manufacturing and distribution assets will be impacted by local legal requirements, as OEMs and suppliers acquire or build capacity for new and evolving technologies. Development of new manufacturing and distribution capacity presents opportunities to leverage governmental incentives for new development. The ability to effectively utilize strategic acquisitions to grow additional capacity is dependent upon understanding applicable legal regulations governing mergers and acquisitions ("M&A") transactions in the local jurisdiction. Meanwhile, the ability to maximize investments in new technologies and manufacturing assets will depend in large part on the ability of industry participants to understand and adapt to the differing labor markets and legal requirements in the various countries where they do business.

ANTITRUST ISSUES

Characterized by high fixed costs, a need for constant innovation, and evolving safety and environmental regulations, the automotive industry has long turned to joint ventures ("JVs") as a way to manage cost and risk among participants. In recent years, demands related to electrification, fuel efficiency and lightweight materials, and autonomous driving have accelerated those pressures. While JVs can lower input and production costs, foster investment in innovation, and facilitate expansion into new markets, they also can trigger antitrust scrutiny during both formation and operation.

As the use of JVs is expected to increase, it may render parts of the supply chain redundant, creating an environment for removal of participants from the supply chain or the use of JVs at the supplier level to reduce costs. Many global antitrust merger filing laws, including in the U.S., apply to investments and joint ventures, as well as outright M&A. Whether a transaction requires a merger filing depends primarily on its structure, value, ownership, control, and the size of the parties involved. These factors have necessitated filings in numerous past automotive industry partnerships, including Ford's recent electric vehicle investment in Rivian, and the creation of the Covisint JV among five automotive OEMs and two tech companies in 2000. If a U.S. filing is required, the parties cannot proceed with their JV until the Department of Justice or Federal Trade Commission ("FTC") have reviewed and cleared it.

In addition to being mindful of merger filing laws, because automotive industry JV partners often remain competitors outside of the JV relationship, the JV must be carefully tailored to avoid running afoul of other antitrust rules once up and running. Antitrust enforcers view with skepticism any operating terms or decisions that reduce JV participants' incentive to compete or that reduce output, quality, or innovation. Protections such as firewalls and practical operating guidelines can reduce antitrust risk from information sharing,

and also help defense arguments during enforcer investigations. Most famously, the FTC intensively investigated GM and Toyota's 1980s venture to manufacture a line of subcompact cars for the U.S. market, ultimately imposing limits on both the scope of the vehicles produced and the types of information exchanged to ensure GM remained incentivized to develop other small car models and to eliminate opportunities for the parties to collude.

TAX IMPLICATIONS

Automotive industry participants should carefully consider the potential tax consequences and planning opportunities across all affected geographies when evaluating global supply chain changes. Any exit from activities in a foreign jurisdiction could trigger U.S. or local tax on wind-down or on transfers of assets, including intellectual property. Entry into any new jurisdiction requires an evaluation of direct or indirect tax burdens such as customs or value-added tax ("VAT") requirements and transfer pricing adjustments, as well as tax incentives.

Additionally, automotive industry manufacturers must evaluate whether any pandemic-related pressures on their supply chains have already had collateral impacts on their tax profile, necessitating tax optimization planning. For instance, any shift of production from one foreign facility to another or from a foreign facility back to the United States implicates numerous tax considerations. Implications could include the relative tax rates as among countries, the availability of tax treaties to avoid double taxation, the taxation of any actual or deemed intercompany payments or debt forgiveness resulting from the shift, the impact under the U.S. minimum tax applicable to the foreign earnings of U.S. multinationals, and the availability of export incentives. Further, labor shortages and reduced production could impact existing local tax incentives, and major changes in financial performance could affect the value of a company's intellectual property and other assets, thus impacting a company's effective tax rate and tax planning. Remote work and travel restrictions could also impact a company's filing position across jurisdictions.

Any tax planning in connection with supply chain decisions must be made with an eye to the evolving U.S. and international tax landscape. The Biden administration has proposed sweeping changes to the international tax system that, if enacted, would greatly impact supply chain structuring, including introducing a 15% minimum tax on certain large corporations, eliminating the favorable tax rate applicable to certain U.S. export income, significantly raising the U.S. minimum tax rate on foreign earnings of U.S. multinationals and eliminating global averaging in calculation of the tax, and denying deductions for certain payments made to parties in low-taxed jurisdictions. At the same time, international cooperation efforts by the OECD and the G20 aim to incentivize the worldwide adoption of a global minimum tax to prevent the shifting of profits to low-tax jurisdictions in an attempt to level the playing field among jurisdictions, while various countries are adopting their own versions of tax reform. As new tax measures become law, they will impact the most tax-efficient choice of jurisdiction for every point in the supply chain of an automotive industry manufacturer.

TREATY AND REGULATORY ISSUES

Prior to the pandemic, fraught geo-political tensions were causing countries to reorient relations with trading partners. From the new U.S.-Mexico-Canada Trade Agreement to trade wars between the U.S., China, and the EU, the shifting sands of global relations were already impacting how countries and global organizations thought about global supply chains. The pandemic only caused these issues and risks of the reliance on sole sourcing for certain commodities and parts within single countries to come to the forefront.

Faced with real fears about the reliance of domestic manufacturers on foreign supply, governments have worked to push the issue and force domestic companies to reduce risk. From increased review by the Committee on Foreign Investment in the United States to U.S. export controls for the export of key items and technologies to China issued in April 2020, December 2020, and July 2021, to the February 2021 Executive Order on American Supply Chains, increasing intersection of national security, economics, and supply chains have created a difficult, constantly changing environment for global automotive supplies. These entities must maintain robust compliance programs for their supply chains and must stay on top of the constant new developments.

JONES DAY AUTHORS

Thomas M. Wearsch
Partner, Business Restructuring & Reorganization Practice
+1 216 586 7015
twearsch@jonesday.com

Brian West Easley
Partner, Labor & Employment Practice
+1 612 217 8845
beasley@jonesday.com

Colleen E. Laduzinski
Partner, Tax Practice
+1 617 449 6940
celaduzinski@jonesday.com

Arthur T. O'Reilly (Art)
Partner, Business & Tort Litigation Practice
+1 313 230 7925
atoreilly@jonesday.com

Kelly Rubin
Partner, Tax Practice
+1 214 969 3768
krubin@jonesday.com

Schuyler J. Schouten
Partner, Government Regulation Practice
+1 202 879 3844
sschouten@jonesday.com

ALVAREZ & MARSAL AUTHORS

Charles M. Moore
Managing Director
Alvarez & Marsal
+1 248 303 0277
cmoore@alvarezandmarsal.com

Raulston Boger
Senior Associate
Alvarez & Marsal
+1 312 590 8917
rboger@alvarezandmarsal.com

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