Benchmarking the Automotive Industry in Central & Eastern Europe: Creating and Preserving Value for the Long-term
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Introduction

The automotive sector in Central and Eastern Europe (CEE) has experienced unprecedented expansion during much of the last decade, enjoying the benefits of both growth and investment. Without doubt, the global financial and economic downturn, which has unfolded during the past six months, will have a major impact on the region. The significant decline in consumer demand for automobiles is causing manufacturers to scale back production with a corresponding effect on the supply chain. Manufacturers and suppliers have already announced job reduction programs in the region and it is likely that this will continue throughout much of 2009. However, CEE’s reputation as a cost-effective and productive manufacturing location means that the medium-term outlook is broadly positive and the issue of value remains forefront in the minds of the region’s automotive executives.

Considering the current environment, executives are no doubt focused on preserving the value they have created over many years during an era of significant change in one of the world’s most dynamic regions. This requires many tasks, for example conserving and maintaining cash while simultaneously retaining highly skilled human resources. It also mandates the ability to identify and manage numerous risks, often originating outside the regions’ borders, yet landing squarely on the door step of local economies with frightening speed.

But executives are equally concerned with creating value. So while risks confronting the automotive sector and the region may indeed be increasing, some players will likely consider industry upheaval an opportunity to find new platforms for medium- and long-term growth in both profits and revenue.

To assist executives in the region’s automotive sector in gaining insights into value creation and value preservation strategies this survey seeks to benchmark a sample of automotive sector companies operating in key countries of Central & Eastern Europe, including the Czech Republic, Hungary, Poland, Romania and Slovakia against their global manufacturing peers. We benchmarked this sample both against the automotive sector and again against a wider sample of industrial manufacturing organizations.

To our readers, we believe, and hope you agree, that the knowledge provided in our survey is beneficial, whatever your role in the organization or the sector as a whole. To the executives who participated in the survey our heartfelt thanks for your time and efforts to assist this endeavor.

Andrew Sutherland
Head of Automotive Sector for KPMG in Central & Eastern Europe
The emerging markets of Central & Eastern Europe (CEE) are sometimes considered undersized markets, especially relative to the often mentioned BRIC countries: Brazil, Russia, India & China. However, when it comes to the automotive industry, the region is increasingly oversized, as “original equipment manufacturers” (OEMs) and suppliers continue relocating to the region for a broad range of factors including the cost and quality of the workforce; its ideal location at the nexus between east and west; as well as an increasingly favorable tax environment.

But as suppliers and OEMs continue to set up new facilities and new operations – either through green fields, acquisitions or joint ventures – the array of management challenges are increasingly complex. Therefore, in this survey we have asked automotive executives for their key insights into issues that cause the most concern as well as their approach to solving these problems.

We have also attempted to go one step further. To assist executives in their decision making we have benchmarked those insights from executives in the region and compared their approach to three separate groups:

- Global industrial manufacturers – our proprietary database of over 260 industrial manufacturing companies
- Global automotive manufacturers – a subset of our database comprising over 130 vehicle manufacturers and component suppliers
- High performing companies – those companies who met our criteria for outsized financial performance, representing approximately 5% of companies in the database (please see our sidebar below: Making the grade).

In a global economy where emerging markets and industrialized economies often follow divergent paths, it is somewhat of a surprise that one of the main themes to emerge from our survey is the continuing integration of the CEE region into the global economy, and these countries’ continued convergence with the developed economies in Western Europe and the US.

As an overall message we see this is largely positive, and to some extent the region is enjoying the best of both worlds. For example, as with the more established EU states in Western Europe, the region and the industry are starting to achieve a critical mass of infrastructure after almost two decades of extensive investment. Also, the stability of EU membership has substantially reduced risks typically associated with emerging markets, where a lack of transparency around financial, legal and environmental regulations can cloud a company’s true performance.

At the same time, these countries are also achieving outsized growth as markets are still far from saturated. The Czech Republic, for example - the country in the region with the highest levels of car ownership - still has less than 80% the ownership levels of the UK and Germany, while Romania’s ownership is barely 45% of these levels.
There are however, several key caveats to this generally rosy picture. For instance the overall growth and profitability profiles are beginning to match the less-than astounding numbers found in mature economies. While the majority of survey respondents from the CEE automotive sector were able to post double digit revenue growth and profit margins, the financial performance profile of the these companies tended to match that of participants in the global industry.

Nevertheless some key differences between emerging and mature markets come to light in this survey, and from which automotive executives and their organizations can learn key lessons. These differences were most pronounced in the areas of Risk and Operational Efficiency, as companies in the region experience inflation, strong currencies, rising wages and increased operational and supply chain risk.

Hopefully, executives and their companies can benefit from these insights when tailoring their strategies and executing their plans across all realms of the organization including Strategic Development; Risk Management; Operations & Supply Chain; and Regulation & Compliance. Key highlights of our findings are as follows:

- When it comes to spending on key regulatory and compliance issues, companies operating in the CEE region fell very much in line with the global averages across all industries, as well as with the automotive sector. One difference however, was spending on environmental compliance, which was less for regional automotive companies.

- Overall, high performing companies are spending more and applying more capacity towards compliance issues.

- The approach of the CEE automotive sector to regulatory and compliance issues was also very similar to the typical global participant in our survey in that most companies tended to integrate compliance into company processes. This differs however from the approach taken by high performing companies, who are more likely to add on more resources for compliance issues, make greater use of third party providers, and tailor their approach specifically to each country, rather than have a standardized, one-size-fits all solution.

- There appear to be stark differences in how the regional automotive companies perceive Risk in several key areas, most notably financial risk, operational and supply chain risk, and labor risk. These are very likely driven by conditions on the ground in CEE which include inflation, strengthening currencies (a danger for exporters), rising wages and an increasingly tight labor market, particularly for skilled labor. High performers see financial, macroeconomic, regulatory, IT, and tax risk to be greater, relative to the average CEE company, than risks such as the supply chain.

- And supply chains, although increasingly global, are nevertheless perceived as fragile. With many small players the market is still fragmented, implying that reliability and quality of supply are not necessarily at the levels of the more developed markets. This is wreaking greater havoc for automotive companies where JIT systems are more common place, as companies are finding it more difficult to accurately forecast demand and therefore efficiently schedule production.

- In terms of strategic decisions that drive growth, automotive companies in the CEE region differ from their global counterparts as they are relatively more likely to seek growth through new markets. Both high performers and average companies preferred to capture new customers in existing markets as a growth strategy. This may be driven by the small size and structural elements of the countries in the region, positioning them as largely export markets. Also, high performers tend to enter new markets through acquisitions rather than JVs or greenfield operations.

- Preferred corporate structures for companies in the CEE region differ from their global counterparts in that joint ventures appear relatively more popular, and outsourcing operations as a way to enter new markets is not a strategy any of the companies in the region pursued. Companies in the region also appear more hesitant about acquiring brown fields as a market entry strategy. Regional and global players appear similar, however, when it comes to building green field operations, as this is slightly more popular for regional companies than the average global player, although still in-line.

- Auto companies in CEE are facing rising labor costs at a much higher
rate compared to the average global player in our survey. This issue appears to be a double-edged sword for companies as they try to have the best of both emerging and industrialized markets. Unfortunately, development and stability come at a price which in the automotive industry is clearly a cost squeeze due to a severe shortage of labor, in the industry, and rising wages, generally. The good news is the region is also posting productivity gains that are generally trending above inflation, meaning that in real terms wages are actually steady or even declining. The question is whether the automotive sector is enjoying this benefit to the same extent.

- When it comes to sourcing from low cost countries, companies in the region appear a bit behind the curve relative to their global counterparts, and are less engaged compared to the other peer groups. However they are more likely to be considering sourcing from low cost countries, particularly for raw material and components. This may be a result of rising wages and inflation in the region as many countries, once considered low cost countries, are increasingly less so, and hence are looking further east for cost savings. Surprisingly, high performers were not taking advantage of low cost country sourcing options but did appear to be getting advantages from leveraging their IT infrastructure and tax planning.

- Tax optimization strategies appear to be an area where the automotive sector in the region is less likely to have fully leveraged potential saving opportunities. On balance, companies in the region are less likely than their global counterparts to have achieved their optimal tax rate, and at the same time companies are more likely to be planning to improve their tax liabilities in the near future. This outlook is potentially driven by already low tax rates and an increase in flat taxes in the region. The exception to this is Hungary where personal and social taxes on employees are having a negative effect for many companies.

2 Methodology

This report, which focuses on the automotive industry in Central & Eastern Europe, is an extension of an earlier study on global automotive and industrial product manufacturers. The original research for this study includes a questionnaire which was answered by 25 companies in five countries within the Central and Eastern Europe region (The Czech Republic, Hungary, Poland, Romania and Slovakia) during a six-month period from October 2007 to March 2008. The questionnaire used for the Central & Eastern European study was based on the questionnaire used in KPMG’s Global Manufacturing Benchmark Survey, where 269 interviews were carried out between late Spring and early Summer 2007.

Our final analysis and interpretations are based on the combined data set of surveys conducted in the region and globally. Additionally a select number of supplementary, qualitative interviews were carried by the author with regional automotive executives and industry analysts. Finally, publically available data from market research firms, the media and KPMG International were used to assist in evaluating the proprietary data and provide qualitative examples in support of the quantitative analysis. We would also note that our research was conducted prior to the full scale unfolding of the financial and economic downturn of 2008. This is a potentially limiting factor to our survey.
Only about 5% of the companies were able to claim the mantle of “high performing” in our survey. To achieve this status companies were required to report both annual revenue growth and pre-tax profit margins greater than 15%.

3 Financial Performance – Determining the High Performers

Making the Grade
What constitutes high performance can be a tricky question. There are many different measures for gauging performance and every executive and analyst has their preferred method for measuring the health and value of an organization. Market share, market capitalization, return on equity, total assets, and so on are all valid measures and tell similar stories – so how to pick the correct measure?

In the final analysis there tend to be three measures upon which most others rest, and which fundamentally drive underlying asset values for an organization. These are the annual growth rate of the firm’s revenues; the relative profitability of the company, or its profit margin; and the sustainability of these margins and growth rates over time, or its risk profile.

In this survey we have chosen to focus on the first two elements as the best way to compile a current snapshot of company performance. While realizing that profits in the future are more important than profits from the past or even today, establishing accurate forecasts for the companies in this survey was beyond the scope of this study.

Likewise obtaining data about each company’s past earnings and revenue was prohibitive, such that we were unable to obtain a reliable indicator for earnings’ volatility and accurately incorporate risk in any quantifiable way into our measure of a high performing company.

Nevertheless, our criteria were stringent enough such that only about 5% of the companies were able to claim the mantle of “high performing” in our survey. To achieve this status companies were required to report both annual revenue growth and pre-tax profit margins greater than 15%.

This elite group proved to be quite diverse, but one that well represented our sample. Some facts about the demographic breakdown include:

- Both large and small companies were represented, with sizes ranging from total revenues of just over USD 200 million, to over USD 20 billion. The median annual revenue for the high performing peer group was between USD 300 and 400 mln.

- All main global geographic regions were well represented including 30% of companies coming from Europe; 60% coming from the Americas; and 10% from Asia.

- Automotive companies made up almost one-third of the high performers (30%) with industrial manufactures representing slightly more of this peer group (40%), with metals producers (10%) and other industries (20%) making up the remaining share.

- Major emerging markets were also well represented as 50% of the high performing peer group came from the BRIC countries (Brazil, Russia, India, and China).
Figure 1: In terms of pre-tax profit margins, in approximate terms what is your company’s current profitability?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Figure 2: What is your company’s forecasted annual revenue growth over the next three years?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
4 Regulation and Compliance

In a post-Enron world, the regulatory and compliance environment for business across the globe is more complex than ever before. Perhaps more frightening, is the ever increasing rate of change of regulation. Take for example one European Auto supplier grappling with International Financial Reporting Standards (IFRS): “It would not be an issue if you didn’t have any changes to the regime – the problem is there are continual changes”. And while it’s true that the impact will vary across different industries and geographies, in many respects the automotive industry in CEE appears to be feeling the impact, and responding, in very similar measure as other automotive and industrial manufacturers across the globe.

The typical response for most companies in our survey is to integrate compliance processes into existing processes. This has largely proven an effective method from a cost point of view. While the costs can be significant, they are largely manageable with companies typically estimating costs on the order of 1% for both financial and environmental compliance costs. This appears to be good news for the auto sector in CEE. According to Gartner Group, an integrated approach is in line with best practices which suggest that companies who take individual solutions for each regulatory challenge can potentially face costs many times over compared to companies who take an integrated approach.

It’s also important to point out that looking at cost alone can be deceiving, as the burden of management time can impose significant costs in terms of lost opportunities which are impossible to calculate. As one executive at a leading auto parts manufacturer puts it, “for us, compliance is more an issue of management discipline than it is a cost issue.” This appears to be even truer for the auto sector in CEE due to the significant strain on resources these companies are experiencing. Virtually all respondents who viewed regulatory issues as a significant risk found not having enough resources to be a significant challenge (please see figure 3).

Interestingly the high performing companies in our survey were more likely to take a different approach and spend more money than the typical company we interviewed. These companies were more likely to set up stand alone processes, outsource compliance activities to third parties and use different approaches for different countries. While this may seem counter intuitive, it may be the case these companies are more forward looking and treating compliance costs as much as an investment for the future than a one-off cost in the current period.

According to one analyst, John Haggerty at AMR Research Inc., costs incurred now can bring future benefits. “The way I look at it, you have to spend money now to save money in the future. In order to make compliance a repeatable and sustainable process, companies should automate as much as they can so that human-related costs can drop over time.”

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Observations and Implications from Regulation & Compliance

In this regard the CEE automotive sector tended to mirror the results of the typical company from our survey. Because few companies chose to handle financial regulations and corporate governance outside their normal processes (see Figure 3) it is possible that these issues are relatively straightforward and well understood. However, given that high performers tend to spend more on compliance it may also be the case that there are opportunities for going “beyond compliance” in the areas of corporate governance and financial regulations. This potentially signals there are opportunities for adding value in these areas that many companies are not necessarily grasping.

Figure 3: How do you handle compliance with financial regulations and corporate governance?

![Figure 3](image_url)

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Single vs. Multiple Approaches to Regulation

And while standardization and integration appear to be the norm, a “one size fits all” approach is not the most popular and is used only about one-third of the time for all companies and less than 20% of the time in the case of high performers (see Figure 4). A very similar approach, or one adopted for local regulations, is used almost half the time for the typical company in our survey. This is the case for both high performers and all companies. High performing companies are more likely (30%) than all companies (20%) to have different approaches for different countries.

The CEE auto sector seems to be slightly more aware of subtle differences as this peer group tended to adapt their compliance to local regulations about 50% of the time and only used the same approach about 20% of the time.
At least some degree of customization appears either necessary or desirable for dealing with regulations and corporate governance across all companies. High performing companies are possibly able to see the value in customizing how they deal with financial regulations and corporate governance issues in the different locations in which they operate.

**Figure 4: Do you use a single approach worldwide to comply with financial regulations & corporate governance?**

Global vs. Local Approach for Tax Compliance

Survey participants from the CEE auto sector by-and-large used a local approach (60%) when addressing tax issues, although a significant portion (40%) took a global approach (see Figure 5). This is interesting in light of comments later in the survey indicating there is some opportunity for better optimizing tax rates.

High performing companies (50%) are more likely than all companies (about 33%) to approach tax compliance from a global perspective. Interestingly, a large percentage of high performers nonetheless tend to handle compliance locally.

Taking a global approach to tax compliance is a relatively recent trend, arising from the increased regulatory responsibilities of finance and tax officers. Many multinational companies (MNCs) have more or less completely out-sourced tax compliance outside their home country to reduce (or shift) regulatory reporting risks. Benefits of doing so include better information (provided by the sophisticated software used by outsourcing vendors), lower process risk, and lower regulatory compliance risks.
Environmental Regulations

The biggest concerns for the CEE auto sector are issues relating to worker’s health and safety – a response in line with the overall competitiveness of the labor market and a general concern for local regulations over global regulations. High performers were more likely to view hazardous waste (55%) and water usage (45%) as significant issues than were all companies (49% and 29%, respectively), but less likely (23%) than all participants (54%) to view carbon emissions as a significant issue (see Figure 6).

In terms of the regulatory impacts of climate change this may indicate some doubts as to the degree of government intervention. It may be the case that the impact of carbon emissions on financial performance is limited, despite its being high profile in the media and public perception. Nevertheless companies need to be aware of the significant likelihood that environmental issues related to climate change will be regulated through market-based policies rather than traditional control and command legislation. It may be the case that the impact of carbon emissions on financial performance is limited, despite its being high profile in the media and public perception.

Given the attention paid by high performers to waste and water, it is possible that pressure to manage these costs is coming as much from clients and supply chain partners as from government/regulation. This could be due to the immediate and visible nature of these costs and represent an opportunity to save money.
Figure 6: Which are the most significant environmental regulation issues that your company is currently facing or is likely to face in the next few years?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Figure 7: What do you estimate is the cost impact of environmental compliance as a percentage of total sales?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Compliance Costs for Finance and Corporate Governance

Again, the CEE auto sector also appears to be paying less in compliance costs for financial and corporate governance related compliance than the rest of the survey participants. If this is indeed the result of laxer regulations rather than more efficient compliance processes, then companies probably need to consider how this might change in the near future.

Overall, more than 60% of all companies estimate financial and corporate governance compliance costs to be less than 1% of total sales (see Figure 8). About 20% of all companies estimate costs at between 1 and 2%, and less than 15% of companies at greater than 3%. In contrast, about 60% of high performing companies estimate the cost of financial and corporate governance to be more than 1% of total sales and more than one-third of high performers estimate costs at greater than 3%.

As with environmental compliance, high performing companies clearly estimate the cost of financial and corporate governance compliance to be more significant than do all companies.

The question seems to emerge as to whether compliance is just a cost or is in fact an investment. This is further evidence of a ‘beyond compliance’ theme continuing to emerge in this survey.

Figure 8: What do you estimate is the cost impact of financial/corporate governance compliance as a percentage of total sales?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Tax Planning

More than 75% of all companies estimate at least some cost savings derived from tax planning (see Figure 9). The profile of the CEE auto sector is similar to that of the typical company. High performing companies tend to see greater benefits from tax savings, on the whole, than all companies. Over 60% of high performers saw the benefits of tax planning exceeding 3% of total sales compared with less than 30% of all companies seeing similar savings. Tax planning to reduce all tax costs appears to be more standard among high-performing companies.

Figure 9: What do you estimate to be the cost savings you derive from tax planning? Please estimate this as a percentage of total sales.

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
5  Risk

In today’s climate, Risk is truly a four letter word. The housing crisis which started heating up a year ago in the US appears to have found firm footing in the UK and pockets of the European continent. At the same time auto sales in the US have plummeted to depths not seen in decades with annual sales declines in the double digits. Europe as a whole appears to be following suit. The latter, of course, is driven by high gas prices while the former is more complex, apparently a combination of speculation, lax regulation and plain old fashioned greed, from Main Street to Wall Street. The net result, of course, is both the US and the largest European economies are entering into a recession, with no end in sight, with the potential to bring the global economy along with it.

Yet, it would seem that many companies and industries in the CEE region are successfully skirting the potential disasters that seem to be just about everywhere. To explain this phenomenon, Dr. Daniel Thorniley of the Economist Intelligence Unit likens the CEE region to a “fat boxer.” “Whenever the going gets tough, the CEE markets have several layers of fat protecting them from global downturns”5, explains Thorniley.

The key advantages for many countries in CEE - which are protecting the region as a whole – include:

- Strong GDP growth;
- EU accession; political stability;
- A strong and growing SME sector;
- High productivity levels;
- A restructured and well functioning banking sector;
- Low inflation; and
- Strong currencies.

All of the above imply that should the global credit crunch manifest itself in the region the downside could be limited by these buffers6.

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5 Dr. Daniel Thorniley, The “Fat Boxer” story turned out to be true: Reasons why the CEE region is still doing so well - The Economist Intelligence Unit. December 2007 p. 4.
6 Dr. Daniel Thorniley, The “Fat Boxer” story turned out to be true: Reasons why the CEE region is still doing so well - The Economist Intelligence Unit. December 2007 p. 5.
Many of these advantages are indeed proving to be beneficial for the region’s automotive sector, as well. For example, Foreign Direct Investment in the region’s automotive sector has been booming for years and appears to be going strong. Nevertheless, companies would certainly benefit from heeding the hard lessons that many companies are learning in the US and elsewhere.

For the region’s automotive sector, financial risk, operational & supply chain risk, and human resource-related risks all stand out as the most significant dangers threatening financial performance. Looking deeper into the issues around financial risks, inflation and strong currencies are clearly perceived as the biggest threats.

The effect of strong currencies potentially has a very different impact on the auto sector than the economy as a whole, for most of the counties in the region. Strong currencies are generally good for the purchasing power of households, who depend on many imports for basic necessities such as food and clothing as well as more durable purchases such as white goods and automobiles. This is increasingly so as rising real wages in the region mean a strong and growing demand for pricier and higher quality imports.

For the automotive sector, however, which is mostly export driven - with many suppliers being paid in Euros and most costs in local currency - the impact is significant. For example, according to a tier one auto parts manufacturer, “The strength of the Czech koruna has caused us to completely revise our financial result for the fiscal year.”

Inflation pressures are also taking their toll on the automotive sector. With oil prices spiking upwards, commodities in general are at an all time high, including many of the key inputs needed for the sector including aluminum, steel, alloys, glass and petro-based chemicals for inputs to plastics. But the trouble hardly stops there. Both strong FDI and surging GDP growth have left unemployment levels at an all time low meaning wage inflation - which is happening anyways - is especially fierce in the automotive sector. In many countries, especially in the Czech Republic and Slovakia, but even in Hungary, some manufacturers are resorting to immigrant workers to keep production lines fully manned. Even though the benefits of a highly productive work force are offering some relief, it is impacting the sector and it’s overall business performance. For this reason, executives are concerned not only with rising wages but even more so with recruiting and retaining staff.

7 Based on KPMG interviews carried out by the author of this report.
Observations and Implications from Risk Related Issues

The overall economy appears to be of biggest concern for all companies and high performers alike, while for the CEE auto sector, financial risk; operational & supply chain risk; and human resource-related risks are more top of mind (see Figure 10). On balance there is not a significant distinction between high performers and all companies with respect to which risks are perceived as more threatening. When it comes to risk the biggest differences between high performers and all companies are in the areas of macroeconomic risk, financial risk, regulatory risk and operational risk.

Possible explanations are that high performers may be more concerned with external risks, which are more difficult to control, such as economic and regulatory environments. Internal risks, on the other hand, such as operational and supply chain issues, which are more directly under corporate control, are less of a concern for high performers. The “other” category consisted mostly of issues relating to new competitive forces and increased awareness of impacts from environmental issues.

Figure 10: Which areas of risk are top of mind for your company and most critical for the industry?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Reputational Risk

High performing companies do not see reputational risk as a significant issue whatsoever.

Very few companies overall saw it as an issue and the auto sector in CEE was much in line with these results. Those who did see this as an issue regarded CSR issues and investor relations to be most significant.

Managing the company’s reputation is increasingly important for all companies but appears to be less so for high performers. Also, it appears CSR is perhaps a difficult topic to get right. There is still no established - or globally accepted - set of rules on how to execute CSR, probably because the topic can mean so many different things to so many different people. Industrial manufacturing and automotive industries are particularly challenged by sustainability issues including emissions, fuel prices, and recyclability.

Figure 11: Which elements of reputational risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Regulatory Risk

High performing companies (20%) were almost twice as likely as all companies (just over 10%) to view regulatory risk as top of mind (see Figure 10). Lack of standard operating procedures; functional barriers; and the inability to access, collect, and collate proper information are the clear challenges faced by the high performers (see Figure 12). The CEE auto sector on balance did not view regulatory risk as a significant challenge.

The implications are that high performing companies are concerned with the efficiency and effectiveness of handling regulatory reporting. It also appears the typical participant in our survey has a less consistent view of the challenges. However, issues relating to competing priorities; difficulty accessing information; functional resources; and managing change were most often cited, suggesting high performers are more proactive than all companies in terms of addressing compliance issues.

For the CEE auto sector, available resources were the clear issue, echoing themes about labor risk, recruiting and retention. Environmental regulation and lack of transparency with governments (particularly in Asia) were issues that factored highly in the “other” category.

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Figure 12: Which elements of regulatory risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Financial Risk

All companies in our survey are concerned with credit risk management processes, including assessing customers and suppliers, credit terms and credit controls. Invoicing speed and accuracy from automated invoicing is important to the high performing companies, as well as for the CEE auto sector. In the category “other”, 60% of respondents identified foreign exchange volatility as a challenge (see Figure 13). Otherwise, survey respondents from the CEE auto sector fell broadly in line with the typical responses.

Possible explanations for these differences are that high performing companies are focused on proactively identifying and managing foreign exchange risk relative to the typical survey respondent.

It is increasingly important to review credit risk management processes in order to lower costs associated with bad debts and write-offs considering the heightened sense of risk since the banking sector fall out over the past 12 months, and amid few signs of its abatement in the near future.

Ultimately, it appears high performing companies are looking for automated solutions to promote accuracy and processing speed in order to collect cash quicker. Also, given the current state of the credit markets companies are evaluating their liquidity management programs to ensure readily available cash.

Figure 13: Which elements of financial risk or liquidity risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Operational & Supply Chain Risk

High performers view integrity of supply; market risk; and financial risk as the biggest issues associated with supply chain and operational risk (see Figure 14). The CEE auto sector is most concerned about forecast accuracy and third parties. All companies are also concerned about forecasting and scheduling and coordinating the supply chain globally.

It is quite probable that high performers have more robust and better performing supply chains given that issues such as coordination, forecasting and scheduling are not an issue for high performers and are for all companies. At the same time, in the CEE auto sector, which is experiencing high rates of change, is clearly struggling to manage demand. This is likely influencing the sector’s ability to manage capacity and productions schedules to the same degree as more stable markets. Global sourcing challenges related to higher material costs factored highly in the “other” category.

Figure 14: Which elements of operational & supply chain risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
IT Risk

High performing companies take security risks more seriously (100%) than all companies (slightly less than 50%) (see Figure 15). Generally, all companies were more concerned with data integrity and system down time, which were not issues for high performers. The CEE auto sector on the other hand was most concerned with data integrity – an issue which possibly related to both the highly dynamic environment in the region, as well as the chronic lack of resources in CEE reported elsewhere in the survey.

Possible explanations are that high performers are more likely to have integrated systems in place. High performers may also be recognizing the link between greater global integration of business systems and higher security management standards. In a more integrated environment, the weakest link in security becomes a weakness for the whole business; therefore the issue of security is more likely to be on the radar screen. Investment in good security management (people, process and technology) is required to address these risks.

Figure 15: Which elements of IT risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Tax Risk

Regulatory complexity is the most challenging risk area for typical companies in our survey (see Figure 16).

And, when combined with the similar “lack of familiarity” category, this group of issues presented the most challenges. For the CEE auto sector, non-compliance was the biggest concern, again echoing earlier comments that CEE is both a highly dynamic environment and one that suffers from a chronic lack of resources.

The proliferation of tax rules and regulations, in all major markets, which are often times conflicting, appears to be a major area of difficulty for survey respondents including those from the CEE auto sector. It is possible that the tax regulatory environment is changing faster than the resources that companies have available to devote to the issue. We would expect companies coping with this complexity to seek simplicity and uniformity in tax-related structuring. The degree and pace of changes in regulation (especially in China) featured highly in the “other” category.

Figure 16: Which elements of tax risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Intellectual Property Risk
Understanding IP protection was viewed as a challenging risk for only 30% of the companies surveyed and less than 10% of companies in the CEE auto sector (see Figure 17). However, we suspect that this risk will become a greater challenge over the next few years and perhaps even more so in emerging markets such as CEE.

To be competitive, companies need to focus not only on product innovations but also on process innovations which increase efficiency and quality. Patenting process innovations prevent other companies using those processes and protect and sustain a competitive advantage. Patent infringement was the predominant risk mentioned in the “other” category.

Manufacturing companies that don’t develop and protect process innovations by patents may need to defend costly IP infringements or pay royalties. Anecdotal evidence suggests that leading companies are already suing their competitors for infringing their process patents.

Figure 17: Which elements of intellectual property risk are particularly challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
**Labor Risk**

Surprisingly all high performing companies – but only 5% of companies overall – emphasized relations with unions while typical companies are finding recruitment and retention difficult (see Figure 18). This is especially true for the CEE auto sector, which also emphasized the cost of workforce as an issue. Few companies are worried about pension costs. Also, labor regulations and worker flexibility were concerns frequently mentioned in the “other” category.

A possible explanation for the high performers focus on relations with unions could be their attempts to squeeze workers while unions respond negatively. However, it seems more likely that fast-growing companies must work closely with unions to ensure workforce flexibility needed for growth. Other companies may be more concerned about recruitment, retention, and wage costs because they haven’t invested into training and motivational programs. In the case for the CEE auto sector, it seems very clear that the influx of investment in relation to the available work force is the main driver. Meanwhile, pension costs may have receded as an issue due to strong financial markets in previous years, however, current market volatility is again throwing valuation into question.

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**Figure 18: Which elements of labor risk are particularly challenging?**

[Bar chart showing labor risk elements and their percentages for different categories: All, Industry, High performers, CEE.]

*Sources: KPMG International, KPMG in Central and Eastern Europe, 2008*
Macroeconomic Risk

High performing companies are less concerned about GDP risk than other companies, while all companies (but especially high performers, and even more so the CEE auto sector) cited exchange rate exposure as a challenge (see Figure 19). Typical survey respondents do not seem particularly concerned about other macro risks such as interest rates and inflation. This is in stark contrast to the CEE auto sector, where inflation was a significant risk within the macro economy. Economic volatility and political stability were mentioned often in the “other” category, especially in emerging markets.

High performing companies may have reduced dependence on overall growth by, for example, taking market share from competitors. Also, high performers may be more exposed to FX risk as they explore new, less mature markets. Ultimately, while the business environment has been benign for a number of years until now (e.g., strong growth and low interest rates), turmoil in financial markets imply that macro risks are rising sharply as fundamental weakness feeds into the global economy.

Figure 19: Which element of macro economic risk is the most challenging?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
6 Entering New Markets

When it comes to expansion opportunities, the countries of Central & Eastern Europe are unique. In many respects they are not like their more easterly cousins including Russia, China and India, as they have much smaller populations, and are more developed with higher living standards. While this environment has its advantages, it also presents business challenges. For example, companies cannot always rely on their home market to continually grow – as these markets are often not big enough to support the revenue requirements of an expanding business. At the same time companies operating in the region are constantly under threat from cheaper imports, typically from China or other parts of Asia.

The CEE region also faces difficulties in relation to its more westerly neighbors. For example, despite a steady track record of almost 20 years, manufacturers in the region are not necessarily at levels of manufacturing capability as those of the EU 15 or the US. This is exemplified in terms of many measures ranging from GDP per capita and levels of infrastructure. One implication of these different levels of development is that customers are not always willing to pay the same prices for products that are perceived as coming from a “low-cost” country.

This means manufacturers in the CEE region must continually reinvent themselves. Fortunately, the region is well placed to do this. For example, although labor costs in the region are increasing, companies are more than offsetting this cost by constantly increasing value. Consider the thoughts of an executive from Rieter Automotive, a Swiss concern with operations in the Czech Republic and Poland: “Costs are rising but you have to factor in productivity improvements in low-cost countries which outweigh direct cost increases. Plus you have more labor flexibility and often a superior work ethic.”

Another clear advantage for CEE companies is their apparent flexibility in entering new markets. Although strategies cited by the region’s auto sector are similar to those cited by survey participants elsewhere across the globe, on balance, companies from the CEE are more likely to choose a new market entry strategy to drive growth rather than relying on existing customers or existing markets. Two issues are likely driving this: On one hand, the size of markets is pushing companies in CEE to be more proactive in looking outside their own borders. On the other hand, the ideal location of many countries from the region – sandwiched in between lower cost regions to the east, and higher cost markets to the west - give these companies a unique geographical advantage.

“Costs are rising but you have to factor in productivity improvements in low-cost countries which outweigh direct cost increases. Plus you have more labor flexibility and often a superior work ethic.”

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Flexibility appears the main benefit from the regional sector's geographical advantage as evidenced by their relative preference to enter into joint ventures, rather than acquisition or greenfield operations. These choices are generally more expensive but often preferred by western companies, as they often come with less day-to-day risk. According to a US executive in the automotive components sector, “The difficult part is not running the manufacturing; it is establishing and maintaining the relationship. You have to be there, you have to know people by name, and it is the only way to make it work.”9 Given the location and cultural similarity of the region it is very likely that companies are more fluid in their ability to be “on the ground” and this reduces the risks perceived by respondents from other geographic locales.

Observations and Implications from Entering New Markets

The majority of companies in our survey rated gaining new customers in existing markets as their key growth strategy, with international expansion less of a priority. Relatively speaking, this was not the case for companies in the CEE auto sector, which were more likely to look abroad than at home. High-performing companies are more likely to expand upon their existing foothold (90%) by winning new customers in existing markets (see Figure 20). Overall, winning new customers was seen as more important than selling more products to existing customers. And while this was also the view of survey participants from the auto sector in CEE, it appears less pronounced.

By all appearances high performing companies tend to take a more considered approach to international expansion. Says one KPMG partner who has advised companies on their expansion strategies, “Growth requires focus – it is a long term effort, its not just about placing flags”10. A slower paced geographic expansion could potentially help companies by allowing them more time to assess the appropriate level of risk and reward.

Also, for companies located in the CEE region, expansion abroad may be a higher priority for at least two reasons: one being that many countries in CEE are small and are quickly saturated; and two, the critical success drivers in the auto industry, such as adherence to JIT schedules, means auto suppliers will locate quickly to wherever their customers go. This latter phenomenon is known as “clustering.”

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10 Based on KPMG interviews carried out by the author of this report.
Entering New Countries

High performing companies overwhelmingly prefer (67%) to enter new markets through acquiring new companies compared with the typical company in our survey (just over 30%). High performers are also more likely to enter markets through third parties (33%) than are all companies (22%) (please see Figure 21). Interestingly, while high performers clearly shied away from joint ventures, companies from the CEE auto sector preferred this format relative to other structures.

One explanation for this is that high performing companies are more cautious when they enter new markets. On the side of the CEE auto sector it is possible that their close ties with their neighbors – geographically, culturally and historically – better enables companies from the region to assess risks from joint venture partners.

In terms of the popularity among high performers for acquiring businesses rather than either building green fields or entering into joint ventures, the fact that existing operations require less capital expenditure and deliver immediate return on assets is a distinct advantage.
Joint Ventures

While for the typical company there appears no clear priority as to why companies do JVs, for the CEE auto sector several issues seem to stand out including: the increased speed in gaining market access; learning from the local partner; and meeting regulatory requirements.

For players in the region’s auto sector regulatory issues are cited elsewhere in the survey as a challenge and therefore JVs may be seen as one strategy for overcoming these challenges. Otherwise, technical challenges and operational challenges, which often have higher thresholds in the auto sector, may prove easier with help from JV partners.
JV Challenges

In terms of the key challenges, identifying partners and establishing shared objectives appear to be the key challenges companies face when participating in JVs. For the CEE auto sector, effective control and managing day-to-day operations is also a challenge.

Again these issues are possibly linked to the short supply of labor and the dynamism of the region and the sector, where development has been rapid. The sector in many countries of the region, especially in Hungary and Romania, has gone from almost non-existent to serious global players, in just over a decade.

Figure 22: What are your primary motivations for undertaking the joint venture operations?

Figure 23: What do you see as the top three challenges in participating in, and successfully operating, joint ventures?
7 Generating Value Through Managing Performance

While the auto sector in CEE is increasingly willing to look outside its borders to drive growth and find new customers, these companies are less likely to look to low cost countries for cheaper labor; this is despite repeated concerns about rising wage costs. One of the apparent drivers of this reluctance appears to be potential concerns about quality coming from these regions.

Based on what executives are telling us there appears to be a definite distinction between so-called middle cost locations, like the CEE region, and truly low cost locations such as China. For example one executive from Europe states, “we have more quality issues in high cost locations, than [medium]-cost. We make all our critical components in places such as the Czech Republic... where we have low-cost and the highest quality.”

Manufacturing in places such as China and elsewhere in Asia is generally seen as more problematic. Ultimately, however, it boils down to management issues. According to several executives, it’s about being on the ground and establishing appropriate controls and communication. “Achieving quality from low cost markets is entirely dependent on how long you have had to manage the issue,” says one executive.

In terms of what low-cost countries appear to offer regions like CEE there seems to be a clear pecking order whereby companies in the auto sector are most likely to consider sourcing raw materials, with components coming next in line. Companies from CEE are least likely to consider sourcing manufacturing operations in lower cost geographies.

Observations & Implications from Managing Performance

Surprisingly high performing companies are not big fans of low cost country sourcing. A larger percentage of this group (40 to 60% - depending on what was sourced) did not employ low cost country strategies for a variety of sourcing needs including raw materials, components, and manufacturing (see Figures 24-26). The typical company who took our survey was more apt to employ low cost country strategies, or at least to be considering them, than to be whole-heartedly against them.

Survey participants from the CEE auto sector were most likely to be considering them, rather than showing any clear commitment one way or the other, a possible indication that the auto sector in CEE is still developing and is possibly taking a “wait and see” attitude with respect to material and labor costs. Both high performing companies and typical companies, however, seem to have made a clear decision about whether or not they will engage in low cost country sourcing for raw materials.

High performing companies’ reluctance to engage in low cost country sourcing possibly highlights overstated benefits of purchasing from low cost destinations. In this regard, surprisingly, engaging in low cost country sourcing doesn’t appear to be a differentiator in terms of financial performance.

Figure 24: Are you engaging in, or considering, low cost country sourcing for raw materials?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Figure 25: Are you engaging in, or considering, low cost country sourcing for components?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
**Benefits from Low Cost Country Sourcing**

Generally, there appear to be larger benefits in terms of cost reduction than in terms of quality from low cost country sourcing. The implication may be that low cost country sourcing can be seen as a trade off - where cost savings are achieved while quality may be compromised. This may be a potential reason why high performing companies are reluctant to engage in LCC sourcing.
For all companies, including high performers - but especially for the CEE auto sector - quality assurance appears to be a driving factor in the potential risks that low cost country sourcing brings with it.

**Risks from Low Cost Country Sourcing**

For all companies, including high performers - but especially for the CEE auto sector - quality assurance appears to be a driving factor in the potential risks that low cost country sourcing brings with it (see Figure 28).

But high performing companies are more likely (33%) than all companies (5%) to be focusing on potential tax benefits from operating in low cost countries. High performing companies are also less concerned (16%) than all companies (38%) with their supply chain. Political and economic stability local competencies, and hidden costs including overheads, lead times and service were all mentioned in the “other” category.

It is possible high performing companies are more likely to consider taxation in their business case for off shoring. As an example – companies who save 10% on costs by outsourcing from the EU to Asia can unknowingly be burdened with a 14% customs obligation and their forecasted 10% gain becomes a 4% loss. Given that supply chain and quality assurance issues are less of a concern for high performers, it's possible they have these issues under better control than does the typical company from our survey.

**Figure 28: Which is the biggest risk or challenge in low cost country sourcing?**

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Managing Inventory

While most companies in our survey are satisfied with their inventory levels, the companies from the CEE auto sector were evenly split – 50% felt they were too high, while 50% felt they were appropriate (see Figure 29). Interestingly no company said they were too low. Generally speaking, reducing inventory, and more broadly working capital, is an opportunity for companies to sustainably release cash. In the current global climate, generating cash from working capital rather than raising cash through financing to fund growth and expansion is potentially a more cost effective option.

Figure 29: In the current fiscal year are your average inventory levels too high, where they needed to be or too low?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
**Labor Costs**

Rising labor costs, which have continually been cited in this survey as an issue for the CEE auto sector, are yet more proof that this segment within our survey is struggling with the local labor environment. It is the opposite for the rest of the survey participants where there is no clear trend – either for typical companies or high performing companies - in terms of their labor cost as a percentage of sales.

In view of high performing companies who seem less concerned with rising labor costs, it is important to bear in mind that there are alternative actions that deliver similar improvements at lower risk and investment. These include technology and process improvements. Also, anecdotal evidence suggests that high performers are more likely to structure incentives and rewards linked to strategic and financial objectives. Overall, however companies who are able to decrease labor cost while growing their revenue will likely improve overall productivity.

**Figure 30: How is your company managing labor costs – as a percentage of revenue are they increasing, staying the same or decreasing?**

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
IT Effectiveness

The CEE auto sector’s response to leveraging technology was broadly similar to that of the rest of survey respondents. High performing companies are twice as likely (30%) as all companies (13%) to have IT platforms that minimize and automate operational work allowing for maximum focus on management decision making (see Figure 31). A focus on automating processes is the main priority for most companies. Most companies have achieved at least some level of automation (98%) but few have achieved their maximum potential (13%).

Enabling management decision making through reliable, well controlled systems clearly supports better performance. Close alignment between IT and business management is a prerequisite for achieving a focus on decision making. Understanding business processes fully from end to end makes it easier to build IT systems that deliver the outputs required by the business.

Figure 31: How would you rate the effectiveness of IT in your company in terms of operational needs vs. management reporting activities?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Tax Optimization

High performing companies are more likely (almost 80%) than typical companies (just over 60%) to achieve their optimal Effective Tax Rate (ETR) (see Figure 32). Conversely, typical companies are more likely (more than 20%) than high performing companies (10%) to not be achieving their optimal ETR. The response of participants from the CEE auto sector broadly reflects that of the typical respondent.

Based on the response of high performing companies, tax planning appears to be an effective differentiator in terms of financial performance. The complexity of global tax planning is a possible culprit encumbering a certain percentage of companies, leaving them unable to achieve their optimal ETR. Interestingly quite a few companies do not know if they are achieving their optimal ETR. This could be due to poor company data or lack of awareness of the opportunities.

Figure 32: Are you currently achieving your optimal Effective Tax Rate (ETR)?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
All high performers (100%) who have not achieved their optimal ETR plan to do so, compared with about 55% of typical survey respondents companies who plan to do so (see Figure 33). Most companies from the regional auto sector also plan to do so. The average company in our survey is quite often either does not have plans to achieve their optimal ETR (over 30%) or don’t know of their company’s plans to do so (just over 10%). Exceptional financial performance as exhibited by the high performers appears to be linked and/or enhanced by companies’ plans to optimize their ETR.

Figure 33: Do you have plans in place to achieve your optimal Effective Tax Rate (ETR)?

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
When it comes to preserving and creating value, the CEE auto sector appears to be well positioned. The growth of the sector within the region to date, and the continual interest in FDI, overwhelmingly demonstrates this. What is increasingly clear, however is that challenges lie ahead. These include the rising volume and complexity of regulation and the higher risks across a number of areas ranging from supply chain, to currency fluctuations, and labor markets. New opportunities - and pitfalls - also loom from the surging economies of key emerging markets such as Russia, India and China, which offer both low cost sourcing opportunities and new markets for manufacturers.

The evidence put forth in this survey substantiates the notion that the regional sector’s approach is benefiting from lessons learned in the global economy, as well as the integration of Central & Eastern Europe into the EU and global economies. What should also be made clear, however, is that a “one size fits all” approach will not always be a panacea for either value creation or value preservation.

The auto sector in the region must come up with its own ways of doing things to remain competitive. Consider the labor shortages and risk, for example: clearly companies are increasing wages to keep the best workers. But this must also be matched by investments in training and development as well as local infrastructure such as secondary education and highways, to keep the sector competitive. Already many in the region have their eyes set on countries like Ukraine and even parts of the Middle East as potential new destinations.

Of course these decisions are easy to talk about but much more difficult to actually execute. Everyone likes to talk about the need for long term investments, but as former General Electric CEO, Jack Welch famously said, “You can’t grow long-term if you can’t eat short-term.” And what is increasingly obvious is that the auto sector globally faces numerous challenges in this regard. Drastic fall-offs in demand in the US are now hitting Europe. Demand for smaller, more fuel efficient models comes at a time when some companies have been trying to save costs by reducing R&D spend. And the increasing addiction which vehicle manufacturers have for discounting slow moving models is only matched by their proclivity for squeezing their supply base – in many cases to the brink of bankruptcy, and sometimes over it.

But as every cloud has a silver lining, so does this one for the CEE region. As the region increasingly becomes a major global production hub, the questions are not whether the CEE region is a successful one for the industry, but rather for how long. If investments in infrastructure, technology, labor and skills are not made, even in an environment of rising costs, then advantages which the region currently enjoys will surely erode. In a sense, for the region’s automotive industry, this is where the rubber truly meets the road.
9 Appendix: Demographic Distribution of Survey Participants

The following charts describe the breakdown of KPMG’s global database of the companies and executives who participated in our survey.

Figure 34: Breakdown of survey participants by industry

Manufacturing of automotive equipment 14%
Automotive & aerospace components 41%
Industrial & metals manufacturing 45%

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Figure 35: Breakdown of survey participants by company size (annual revenue)

- Less than $200m: 20%
- $200m - $299m: 18%
- $300m - $399m: 11%
- $400m - $499m: 5%
- $500m - $699m: 7%
- $700m - $799m: 5%
- $800m - $999m: 3%
- $1bn - $4.99bn: 5%
- $5bn - $9.99bn: 20%
- $10bn - $19.99bn: 9%
- More than $20bn: 6%
- Not known: 4%

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
Figure 36: Breakdown of survey participants by key market

- Brazil: 32%
- Mexico: 9%
- US & Canada: 10%
- Asia Pacific Other: 7%
- China: 9%
- India: 7%
- Central & Eastern Europe: 8%
- W. Europe: 2%
- Japan: 9%
- Not known: 7%

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008

Figure 37: Breakdown of survey participants by region

- Americas: 28%
- AsPac: 30%
- EMA: 42%

Sources: KPMG International, KPMG in Central and Eastern Europe, 2008
10 KPMG Information

About KPMG’s Global Automotive Practice
KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We have over 123,000 outstanding professionals working together to deliver value in over 140 countries worldwide.

Through its member firms, KPMG has invested extensively in developing a highly experienced automotive team. Our understanding of the industry is both current and forward looking, thanks to KPMG member firms’ global experience, knowledge sharing, industry training and the use of professionals with direct experience in the automotive industry.

KPMG member firms serve many of the market leaders within the automotive sector.

Our strength lies in our member firm network, its professionals and their knowledge and experience gathered from working with a large and diverse client base. KPMG’s industry experience helps the team understand both your business priorities and the strategic issues facing your company. KPMG’s Global automotive practice’s presence in many major international markets, combined with industry knowledge, helps KPMG assist you in recognizing and making the most of opportunities, as well as advising on the implementation of changes dictated by industry developments.

Authorship of the CEE Report
Thompson H. McDaniel, Jr. is the author of this report. In addition to advising KPMG member firms on the automotive market, Tom is a senior lecturer and the director of Supply Chain Programs at the CEU Business School in Budapest, Hungary.
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