The global car industry

Extinction of the predator

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How merger mania has been a disaster for the world's great car manufacturers

THE star of the huge Frankfurt Motor Show, which opens on September 12th, may well be the latest luxury Mercedes-Benz S-class, the model on which the German company is relying to repair its faded reputation for superior quality. But the more significant event at the show will be the presence on display for the first time of three different vehicles made in China by local firms and destined for export. Already the first Chinese cars for Europe's roads are being unloaded in Rotterdam. Plans are well under way for Chinese models to be sold in America as well.

Today's controversies over high petrol prices and fuel-guzzling SUVs in the huge American market offer only a partial picture of the future facing the industry as a whole. It may well be fully mature in markets such as North America, Europe and Japan, where over-capacity continues to sap profitability. But globally the industry is set for huge expansion with the motorisation of China and India. Within a few years China will replace Japan as the second-largest national market after America. Some experts predict that over the next 20 years more cars will be made than in the entire 110-year history of the industry.

Garel Rhys, director of the Centre for Automotive Industry Research at Cardiff University in Britain, says this growth will create the need for 180 new factories, each producing 300,000 cars (and light trucks) a year—in effect, almost doubling the production capacity of the global industry to over 110m units annually. Today's car plants, he says, will need to be "renewed, retooled, refurbished and replaced to remain competitive. There is nowhere for the inefficient to hide."

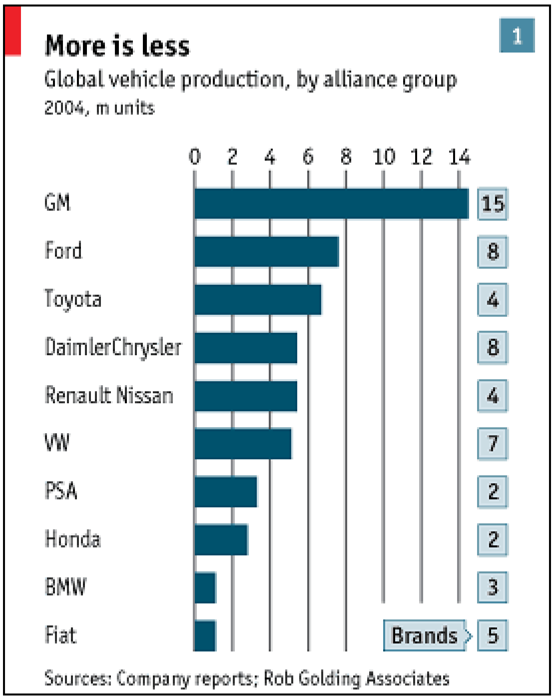
That is a bleak message for today's established big producers, many of which have merged their way to giant status, but remain chronically hampered by legacy costs and operating problems and could now be beaten by new entrants and competitors that have eschewed the merger game. The new car industries springing up in China and India will account for most of tomorrow's extra production. As their output starts to reach markets around the world, the question is: which of today's big carmakers will be hurt the most? Eventually the question could be an even tougher one: which will survive?

Other industries subjected to similar waves of new competition have seen dramatic shake-ups and the disappearance of famous names—personal computers offer a good example. Imagine General Motors (GM) stopping making Cadillacs and Chevrolets to concentrate only on SUVs and developing technology for others to use to make cars. Some observers predict just that: famous carmakers will own the technology and brands, while manufacture and distribution will be contracted out to parts-makers or general engineering manufacturers. (This already happens with a few low-volume cars, such as the Porsche Boxster.)

Consolidation in the car industry has been going on since its earliest days when 200 garage-sized firms were bundled into GM. By the middle of the last century such famous names in America as Studebaker and American Motors were closing down or being gobbled up by stronger companies, leaving the industry in the hands of GM, Ford and Chrysler. In Europe, virtually the entire British car industry was rolled into British Leyland, which was the third-biggest manufacturer in the world at its creation in the 1970s. In France, Citroën was swallowed by Peugeot, though the brand survives, while Simca went into the maw of Chrysler, never to be seen again.

Consolidation in cars is not as starkly obvious to the consumer as it has been in, say, personal computers. A plethora of badges still remains, as mergers and alliances between firms over the years have simply bundled, rather than destroyed, brands. No fewer than 58 brands survive among the ten largest manufacturers. In fact, if their affiliates as well as their wholly-owned companies are counted, the top five company alliances account for 75% of the global market, while adding the next five takes this to 90%, with producers in China, India and Malaysia making up the rest.

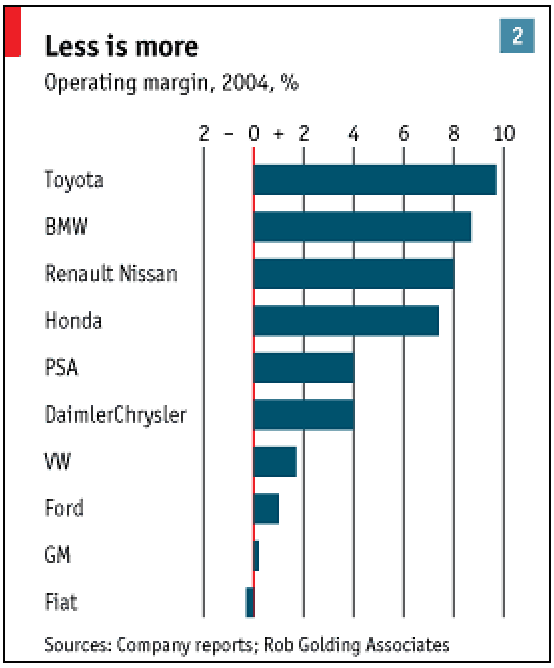
The strategy of consolidating behind the brands has not been entirely successful: indeed there is an inverse correlation between the number of brands a firm possesses and profitability. GM may still be the big beast of the industry, but it is no longer in any shape to gobble up others. It has twice the number of brands of its closest competitor, Ford, but is second to last in the profitability league (see the charts). The same goes for Ford, whose annexation of Mazda and Volvo keeps it just ahead of Toyota in terms of production. Toyota, the industry's profitability champion, has only four brands and a handful of models, but a huge range of variants on them.



The industry has experienced a 20-year splurge that has seen, for instance, GM swallow Saab and Daewoo, while signing up Isuzu, Subaru and Suzuki in Japan, taking key stakes in them in order to share their small-car expertise and gain access to the Asian market. Since 1989 Ford, the next biggest brand-acquirer, has taken over Jaguar, Aston Martin, Land Rover and Volvo, while it has also bought heavily into Mazda. But it, like GM, has done more spending than getting. Jaguar still bleeds cash after an investment topping $5 billion and Volvo has only recently scraped into profit. None of this has done anything for the company's profitability, leaving it languishing just above GM and feeble Fiat.

Seduced by scale

The two biggest consolidation deals in the industry are also the most recent: the takeover of Chrysler by Daimler-Benz in 1998; and the alliance of Renault and Nissan the following year. DaimlerChrysler has been a flop so far. It has taken years to lick Chrysler into shape, slashing its surplus capacity and reviving the brand with new products good enough to drag it back into profit this year. Meanwhile, top management attention was diverted from growing problems at home as quality slid at Mercedes, which lost its long-standing dominance of the lucrative German market to its arch-rival BMW.



The best justification for the Daimler-Chrysler deal, at the time the world's biggest industrial merger, was the growing cost of electronics systems in luxury cars. Mercedes was the world leader in such sophisticated electronics, but it was not a volume car producer, which meant it laboured with a higher cost base. Daimler's hope was that, by buying Chrysler, it could enter the volume end of the car market in one step, and so spread the costs of new technology over a much bigger output. German rigour was supposed to produce rewards in the world's biggest and (for good manufacturers such as Toyota, Nissan and Honda) most profitable market.

It did not work out that way. Daimler and Chrysler together are worth less in stockmarket terms than Daimler alone was before the merger. This summer the architect of the deal, Jürgen Schrempp, was nudged out of his chief executive's chair (he leaves at the end of this year) by leading shareholders as a result.

The deal between Renault and Nissan was a bold move by the French company to gain global scale. Having put its house in order at home, the privatised French company saw its market capitalisation rise as that of loss-making Nissan slipped. So Renault's then chief executive (now chairman) Louis Schweitzer pounced on the opportunity to give Renault global reach and scale. He made the Japanese a friendly offer. But he was cautious enough to take at first only a controlling 37% stake.

The French later increased their holding to 44%, as Nissan's industrial debt was cut by profits and by disposal of the firm's outdated *keiretsu* equity stakes in its suppliers. The deal has paid off as well as the German-American one has flopped. Indeed, Nissan's earnings have been propping up Renault, as the latter has gone through a lean period in the past couple of years, hemmed in by an ageing model range and stagnant markets.

So there are several reasons for the end of takeover activity: the binges of the past have left the predators with, at best, no appetite for more or, at worst, severe indigestion. Moreover, what is left amounts to slim pickings, as GM found when it decided to pay $2 billion merely to go back on a hastily made promise to buy troubled Fiat, after five years of collaboration had shown the Detroit firm how weak its Italian partner was. GM has evident problems of its own—notably the rocketing cost of pensions, health care, lay-off pay and the need to rescue near-bankrupt suppliers. Nevertheless, this surreal episode was a seminal moment. Once the very fact that brands with the glamour of Ferrari, Alfa-Romeo and Maserati were available would have produced a scramble among potential buyers. Fiat's financial difficulties would have been regarded as an opportunity for the predator, not a threat. Today no one wants to take them on.

Nor are the new producers in emerging markets in any position to go on a buying spree. Korea is down to one manufacturer, Hyundai, from the seven it had 20 years ago. China has two dozen established vehicle-builders and start-ups, which will have to go through the normal 10-15-year process of consolidation before one group can emerge that is large enough to gobble up substantial competitors. The very fact that SAIC and Nanjing Automobile sniffed at the remains of Britain's MG Rover and then backed away shows that they are far from ready to take on a living enterprise.

The brand news

The lesson of two decades of frantic mergers and acquisitions in the motor industry is that acquired brands, however strong and attractive they might appear, take years to restore. They first need cleaning up, then bending to the shape and behaviour of the new family. And they need to be fitted out with new products worthy of the badge on the front (Jaguar is the clearest example of this).

GM's unhappy cohabitation with Fiat was concurrent with its ownership of Saab, which it bought as a consolation prize when it was beaten to Jaguar by Ford. Fifteen years later that, too, looks like a mistake. Last year a review was started that ruled nothing out—sale and closure included. A frantic programme is under way to reduce costs through platform and component savings with other members of the GM alliance group, including Subaru and Chevrolet. But using the corporate parts bin is a quick way to cheapen a brand.

And then there is Volkswagen, pride of the European predators. It used acquisitions to expand geographically—first southwards to pluck SEAT in Spain, then eastwards to take over Skoda in the Czech Republic. In parallel with a masterful 20-year rehabilitation of Audi as a prestige brand, VW also snapped up Bentley, Bugatti and Lamborghini from their distressed owners.

Bentley has been a fabulous success with queues of keen buyers for its Continental coupé. Lamborghini has a couple of new Batmobile-type street racers that look good but have not yet turned a profit. Critics want to know how VW will redeem the muddle of Volkswagen, SEAT and Skoda brands all scrapping for the middle market and competing with each other, and what it can do to recover from the recent slide in its share of the American market, where only a few years ago it was zooming ahead. Job cuts in Germany mooted this week, maybe up to 10,000 of them, will not begin to address that problem, but might provoke damaging strikes.

In-breeding as a virtue

The most sensible of the carmakers has spurned the consolidation game. Toyota is still not the world's largest by number of cars built, but given the speed at which it is growing (output has expanded by 1.5m vehicles in the past five years, half the total growth in world production) and the speed at which GM is shrinking, the day when Toyota becomes the biggest is probably no more than five years away. Investors already recognise it as the leader. Its market capitalisation, at $150 billion, is greater than that of GM, Ford and DaimlerChrysler combined ($90 billion).

This superiority has been achieved by concentrating on organic growth. Apart from scooping up Daihatsu to get small-car engineering and engines years ago, Toyota has concentrated solely on improving its own offering, with a relentless focus on efficiency, cost-cutting and a flood of new variations of successful models brought to market at an increasingly rapid rate.

Toyota's luxury car business, Lexus, was created from scratch, rather than by the purchase of some other firm's famous, but tired, brand. Lexus is now the best-selling prestige brand in America. Encouraged, Toyota is spending lavishly this year on marketing it in Europe and Japan as well.

People scoffed when Toyota announced its plans for creating its own luxury brand rather than paying for some other firm's glorious history. But Lexus has been spared all the tears, toil and sweat associated with a takeover. And it has succeeded by following a policy that many makers seem to find hard to copy: give people cars that don't break and treat customers like royalty.

Buying brands and additional international reach have been the strategies behind many takeovers. But so too was the aspiration of using volume to achieve economies of scale. Analysts are no longer sure, however, that there is any great merit in that. Keith Hayes of Goldman Sachs reckons that 500,000 copies off a single platform is about the point at which scale benefits start to drop away. Besides, there are many things more important for the big firms to concentrate on.

In the past, making large numbers of a few models was the way to thrive. Now it is all about making a few copies of a lot of derivatives. Look at the dozens of model categories in today's Mercedes and BMW ranges—a few years ago they had just three each. Yet total sales of each brand are still only around 1m. Creating niches from common platforms is the new way to compete. BMW now sees strong competitive advantage in maintaining differences between all the cars it sells. It is investing in infrastructure so that customers can change the specification of their car as late as 100 hours before it is built. That encourages customers to spend more on optional equipment. For the carmaker it also means that every assembly plant has to be surrounded by its own suppliers. An engine cannot be shipped across continents within 100 hours of a request. Separate factories allow for more variation, but at the price of fewer economies of scale. However, the greater the specification by consumers, the higher the premium price the carmaker can command.

In addition, there are more cost savings available from cutting warranty and recall costs than from maintaining a large degree of commonality among various models. And for many of the big groups—especially the Japanese—there are massive savings to be had from dealing with white-collar inefficiencies. All of these productivity gains can now be achieved without large scale or the headaches of an acquisition.

The obvious conclusion might be that the 100-year-old car industry has done its rationalisation and consolidation and that what remains must therefore be leaner and fitter. It should be, but it isn't. John Murray, chair in Business Studies at Trinity College Dublin, points to a worrying loss of power by the carmakers, rather than the expected gain. The makers have pushed much of their intellectual property away to the first tier of component suppliers, which have taken physical assets along with the necessary skills. And downstream, the new multi-brand retailers and the internet-savvy consumers are together gaining power and a bigger chunk of the value chain. The so-called car manufacturers are going to be left to take care of just design, marketing and brands—a long way from the traditional skill of managing big manufacturing businesses.

The car industry could probably now cope with an implosion of the assemblers, thinks Mr Murray. “An alliance of Tier One component integrators and the new major retailers could happily fill the vacuum.” That is a radical and visionary thought. But at the moment the big component providers are scarcely in the shape to do anything. Delphi, the world's largest, recently considered bankruptcy as one of the solutions to its huge financial problems.

Good in parts

Dizzying price increases lately for raw materials have neatly sorted the sheep from goats. Some suppliers told auto clients that they needed a price increase to compensate and were told to go home and have a long think about it. Others came up with the same speech and got what they wanted because the carmakers needed what was being offered at any price. Saul Rubin, specialist autos fund manager at Rockhampton Management, says that the episode highlighted the quality players. Some suppliers, such as Magna, are frank about the eventual need to have their own final assembly capacity. Non-unionised component companies in America cannot wait to buy a redundant assembly hall after a bankruptcy at GM. That is an investment trend to look out for.

Then, of course, there is just a chance that GM will not implode and instead will become the next Nissan. Implausible recovery stories (Chrysler twice, VW, Renault, Porsche, Nissan) have cropped up every decade and have paid returns far greater than any takeover bid ever did. More likely is that GM, like many of its established big rivals, will go on struggling with the consequences of the industry's consolidation to date. In future, as the global industry expands, new names will join those of Toyota and a few others. Yesterday's predators, obsessed by their takeovers and mergers, will give way to nimbler, smarter carmakers that will reshape the global industry.