



The Centre For Business Relationships,
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Comment and Analysis



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CRISIS SPIRALS IN THE AUTOMOTIVE INDUSTRY

The context: the crisis bites

As the global financial crisis continues to unfold, so the full extent of the damage to the automotive industry is becoming clear. Governments around the world are being called upon to provide funds on a huge and unprecedented scale – GM could require up to US\$30bn just to stay in business – and already emergency remedial actions have been taken to cut capacity, lay off workers and reduce costs. However, a crisis such as this is not a one-off event but an unfolding process which, as is made clear below, can result in a downward spiral of negative feedback loops that is beyond the ability of management to contain. This is a story that applies to individual companies but, as the economic circumstance continues to deteriorate, is increasingly applying to an entire sector such that the major questions being asked now are not so much which companies will be negatively affected but rather which companies are likely to survive at all. This in turn raises some fundamental questions of those concerned with sustainability. On the one hand, this is an historic moment in the history of one of the most implicated of industries when it comes to key themes such as global warming and resource depletion. The immediate impact of the loss of this industry for most countries would be nothing but benign: the production of cars and the materials from which they are made after all accounts for large amounts of energy and in many countries (such as the UK) it is steelworks and engine plants, aluminium smelters and vehicle assembly paint shops that constitute the largest industrial emitters of carbon. Equally, it could be argued that there are enough cars to go around right now, and adding more new ones will not materially aid mobility but might increase congestion. Some observers have called publically for the entire economy to be re-orientated towards non-growth, while others are calling for the end to the rampant material consumption underpinned by the ‘because I’m worth it’ mentality. In this case, vast swathes of the old economy need to be swept away and perhaps the traditional automotive industry is one of the prime candidates.

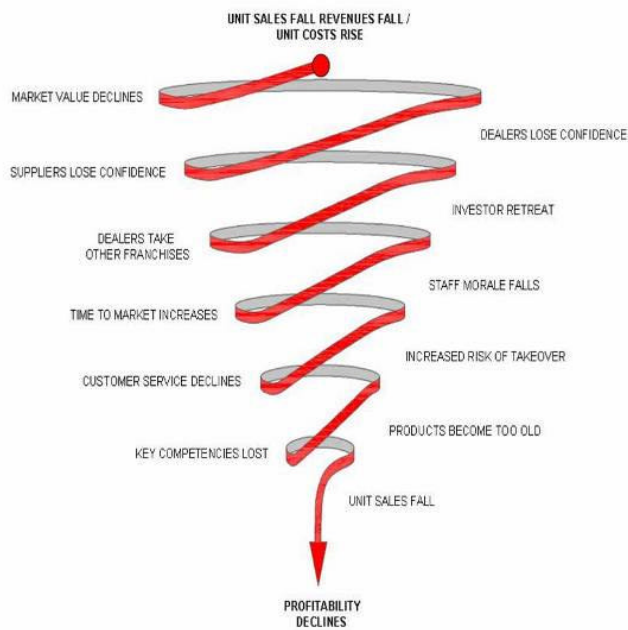
Set against this are other concerns. Of course, there are jobs at stake for thousands of workers and their dependents. Beyond this, however, is the more important long-term question of how we achieve sustainable automobility if the existing industry collapses. For most inside the industry, and indeed those in government, the main argument advanced is that without a short-term survival strategy there is no long term. Ultimately, this is a question of how social resources (suddenly scarce now) should be deployed. It may well be the case that the available aid to the automotive industry is simply inadequate to the task. As this paper makes clear, this is a process of decline that is extremely difficult to reverse.

The start of the spiral

Diagram 1 shows, in stylised form, the process whereby following an initial ‘event’, a company can descend into greater and greater trouble. This downward spiral of negative feedback loops can occur to a single company even when the rest of the industry is doing well (it is after all the long-term story of the MG Rover Group as it unfolded over about 30 years), but when as is the case now the entire sector is in trouble, the concern is that the spiral is even stronger.

Many outside observers would identify the global financial crisis that has unfolded since mid-2008 as the proximate cause or trigger for the crisis that has engulfed many vehicle manufacturers. In reality, this is not so. Major companies such as GM and Ford had been struggling to be profitable in their domestic market and in their global operations since before the millennium. Many others have a history of lurching in and out of crisis despite the expansion of markets world-wide. Many of the traditional solutions in the form of rationalisation, cost-reduction and industrial consolidation have failed to yield the anticipated benefits: the most obvious case being the catastrophically executed merger between Daimler and Chrysler. In other words, the trigger for a crisis tends to expose pre-existing underlying weaknesses. In the case of the automotive industry, the fundamental business model has been flawed for a long time, and most vehicle manufacturers had become reliant on artificially inflated demand via generous finance packages.

Diagram 1: The crisis spiral



The immediate cause of problems is of course a decline in sales. However, while much of the concern has been with crisis and resolution over a relatively short time period, it is also possible for 'crisis' to unfold inexorably over the years. Indeed, some aspects of the negative feedback process described here can take many years for the full effects to be felt by the company. For example, when a crisis hits a company, key design staff may decide to leave and find employment elsewhere. This does not matter for the immediate product portfolio, or even for models largely developed but not in the market – but in a few years time when full replacements are due the quality of the new designs may not be up to the desired level.

As the crisis deepens, so the negative effects are found throughout the organisation, and the negative feedback loops start to develop. For the vehicle manufacturers the following are important:

- Financial community
- Franchised dealer networks
- Suppliers
- Internal resources and competencies

Financial community

Financial markets are notoriously short-term in perspective, with most judgements based not on recent historical performance but that which is to come over the next quarter or next year. This makes financial structures and practices particularly susceptible to reacting rapidly to any extraneous shock or crisis event in a company. Often this impact is reflected in and reported as a falling share price but there are wider implications here too. First, the initial share price fall may trigger secondary or further falls following on as institutional shareholders and others adjust their portfolios. A weaker share price simultaneously makes a company vulnerable to external takeover, and less able to generate the resources to mount a defence. In order to shore up the balance sheet, a company may need to sell assets, but at the same time the debt rating may be reduced thereby making capital more expensive. With fewer assets, the company becomes more dependent upon cash flow as the basis of assurance for investors: falling net worth makes the whole company less attractive to the financial community. Of course, the problem is that with capital more expensive to obtain and with less to invest, there must be cutbacks in the otherwise intended investment programme, either in terms of manufacturing capabilities or new models, or indeed both.

Perhaps the most important dimension here is that the company can rapidly lose control over its own destiny in order to finance some sort of reversal or rescue, whether by the banks, by competitors, by other companies within the same group, or indeed by government. Again, it is significant that these processes may play out over differential time periods. Some, such as adjustments to share price, can happen quickly – indeed such adjustments are the short-term consequences of financial markets assessing the future implications of recent developments. On the other hand, selling off assets in order to generate funds and reverse the crisis spiral may take some time, and equally the more 'distressed' the position of the company the more likely it

is that the full asset value cannot be realised because potential buyers know the seller is increasingly desperate to generate whatever revenues are possible.

It is evident that the US automotive industry has effectively been nationalised, with support from the government conditional upon sweeping changes to operational practice and strategy. At this stage it is not yet clear how other governments will react if the currently favoured soft loans and other schemes fail to provide sufficient support.

There has been much debate about the inability or unwillingness of financial institutions to support the car finance divisions of the vehicle manufacturers, or indeed to provide their own loans to private individuals to enable them to purchase new cars. Ever since GM formed the GM Acceptance Corp. in the early 1920s, the provision of loans to customers has been a key element in the expansion of the market for new cars. Unsurprisingly, the automotive industry was heavily implicated in and suffered deeply from the financial bubble that eventually burst in mid-2008. In effect, easily obtainable and cheap finance artificially inflated the demand for new cars, prompting over-production and over-investment in new capacity such that the industry as a whole became a bloated beast. This is, of course, one reason why attempts to return the industry to the pre-crunch status are sheer folly. Many of the vehicle manufacturers had to write down large losses on their existing loan portfolio to customers because the used car market (and used car values) collapsed alongside the new car market.

More fundamentally, the automotive industry has long been one that has required frequent recourse to external finance, not least because retained profits are often inadequate to the task. Evidently, external finance will be more difficult to obtain into the future. Yet, the industry needs finance more than ever. There are perhaps three main concerns, apart from the usual costs associated with the development of new models and upgrading existing production facilities. The new areas of expense are going to be a) closure costs of outdated or unneeded capacity; the expansion costs of new factories in expanding markets in Asia and elsewhere; the technology costs of meeting the low carbon agenda.

Franchised dealer networks

In the case of distribution and retailing, the initial impact of the crisis may be considered as a fall in sales through the retail and distribution system. As sales per outlet fall, so the confidence of the (usually third party) retail outlet owners falls along with that of consumers. Those outlets that were the most marginal in terms of continued prosperity would generally be expected to be the ones that react first and fastest, for example by seeking to take another brand into the franchise or business. In the automotive industry retailing of new cars is often in the hands of independent franchised dealers. Inevitably, once a single-franchise operation becomes a multi-franchise outlet some sales that would previously have gone to the initial brand will go instead to the new brand, thereby reducing sales overall to the brand under crisis. In some cases, retail outlets may close entirely, thereby exposing gaps in geographic market coverage. In so far as these closed retail outlets are then recruited by competitor brands, the effect is two-fold: the brand in crisis loses sales; and competitor brands benefit from increased sales. In addition, remaining dealers may

become reluctant to invest at former levels such that, for example, the physical fabric of the retail outlets declines, as does the skill level of the workforce due to lapses in training coverage. Once again, therefore, customer service levels will fall and so will sales, thereby accelerating the impetus to decline. For the 'parent' company at the heart of the extended business, the loss of these individual retail outlets will be cumulative, forcing further cutbacks in production. For example, if one dealership point in a network of several hundred is lost the impact on sales will be small, particularly if that dealership point was marginal in any case. The cumulative impact of many similar closures will, however, be large and will be felt months or even years later in the form of reduced sales. Another version of this theme is that it could be the case that it is the better independent franchise dealers that are the most attuned to market change, and hence the more likely to swap franchise representation when things do go wrong. Such 'better' dealerships constitute a more significant loss to the network than their numerical count would imply.

In the US, both GM and Chrysler have announced sweeping cuts to their dealership base thus confirming that in the future their share of the market will be lower. As the industry as a whole cuts back on dealerships there is almost bound to be knock-on impacts on vehicle manufacturer revenues both from reduced new car sales and from lost service and maintenance work – historically a profitable part of the business. Indeed, it might well be the case that empty franchised dealerships will join disused churches, abandoned pubs, defunct petrol stations and decaying neighbourhood stores on the list of urban infrastructure in need of a new application.

Suppliers

In an era of vertical disintegration, supply chain management becomes a vital competitive factor. Suppliers are expected to undertake R&D, to deliver year-on-year cost savings, and constantly improve on quality, delivery and price. At the same time, the number of suppliers is drastically reduced, while contracts are bigger and for a longer time period to enable those suppliers to generate the revenues to support further improvements. All of this in some respects makes the focal manufacturing company rather more vulnerable, and the relationship less one of simple control. Furthermore, as suppliers grow in competence, scope and market coverage so they develop many more customers of their own, and are no longer dependent upon one single manufacturer customer. As a result, suppliers might start making judgements about whether a certain customer is worth retaining in the future, and how much investment should be put in to support that customer.

It can be appreciated that in the automotive industry such investments by suppliers are in two critical areas: product development and proximate supply. If suppliers start to reduce their investments to a particular vehicle manufacturer in product development then it is likely that the pace of new model development will slow and / or there will be some aspects of the new model that are not up to current standards. In either case, the vehicle manufacturer is left competing in the market with products that are less than ideal, being either too old or insufficiently competent, or both. In turn, this will undermine sales and so take the decline spiral around a further iteration. If suppliers start to reduce their investments in terms of proximate supply (i.e. putting satellite plants onto supplier parks alongside the vehicle assembly plant) then it is going to make capacity expansion in emerging markets more difficult for the vehicle

manufacturer. The vehicle manufacturer will thus be left behind in the race for market share in these markets, or indeed in the process of trying to balance revenues from many geographical locations. Thus the vehicle manufacturer will be at more risk from change in a single market, and suffer reduced revenues from failure to participate in expanding markets. In turn, this means that the vehicle manufacturer cannot match the high volumes offered by other competitors, and so the business is less attractive to suppliers.

In the US, great efforts have been made to secure payments to the core Chrysler suppliers such that when the vehicle manufacturer emerges out of Chapter 11 protection there will still be some chance that it will be able to purchase components and materials from which to construct cars. Nevertheless, many key suppliers are themselves in dire financial straits and it is far from certain that all will survive. This in turn provides a crucial limit on the extent to which the automotive industry as a whole can be rebuilt to the scale that it hitherto enjoyed.

Internal resources and competencies

In any case, when problems start to emerge at a company, then recruitment and retention of personnel along with other human resource management issues are potentially going to arise. Once the decline starts to hit on sales there is an inevitable consequence for production. Production slow-downs, and stoppages, temporary lay-offs, and similar related measures hit pay and bonuses and therefore contribute to lower morale. Motivation may also decline, while across the business those with the most marketable skills may start to take up positions elsewhere. There can possibly be a situation, therefore, where the best leave while those that are less able or less attractive to alternative employers stick with the existing employer. More generally, entire communities can be badly affected by these events. In locations dominated by particular companies or plants (most obviously right now, Detroit) the stigma of decline extends to the entire location, such that house prices fall and people are more reluctant to move into the area.

Equally, the physical capital of production may suffer as under-investment starts to erode the reliability and productivity of equipment. Without continuous re-investment it is very difficult to retain competitiveness in assembly processes, or indeed in other areas of the business such as design.

The degradation of internal competencies is rather difficult to measure, especially when considering the quality of the workers involved as well as the quantity. Equally, it is sometimes an opportunity for former employees to take up new opportunities elsewhere or to start their own business. This is more plausible if one company fails but the rest of the regional economy remains robust.

Mergers and acquisitions often do not help this situation. In major mergers there is an immediate search for cost savings. Often, these are supposedly obtained by rationalisation and centralisation of activities such as R&D, purchasing and distribution. In reality what this means is that the weaker company loses those capabilities (this is the story of Rover, and may well apply to Jaguar, Land Rover, and Chrysler to one degree or another). If, as is often the case, the merger subsequently

falls apart the original company is left denuded of key skills and competencies, and is therefore forced into another inter-corporate relationship.

Conclusions

What this shows is that for senior management it is extremely difficult to draw a clear line in the retrenchment and rationalisation process, and thereby to define the point at which the crisis ceases to damage the business. Consumers become increasingly aware of the problems surrounding a vehicle manufacturer or a brand, and the weaknesses of an existing brand can act to accelerate the impact of the crisis. An indication of this is the way in which in the US the government felt moved to announce that it would underwrite the warranties on Chrysler vehicles, in an attempt to reassure consumers.

Governments also have to be acutely aware that the short-term bolstering of a balance sheet may not constitute the long-term resolution of the problems the industry faces. Indeed, a case could be made for suggesting that for at least some of the vehicle manufacturers under threat today, the root causes can be traced back through many years of management decisions. A crisis in this sense has a way of exposing mistakes, just as growing markets can sometimes obscure them. The basic lesson is clear: it will be many years until the full impact of recent events work their way through the entire industry.