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The coming restructuring in the automotive sector will be far-reaching and gut-wrenching. There will be consolidation, but not in the traditional sense: At this juncture there is little point in companies combining to acquire scale or scope. Instead, the restructuring will flush all the noncompetitive assets out of the system. The remaining assets—whether they belong to original equipment manufacturers (OEMs) or suppliers—will be organized into bundles that, collectively, will be significantly more competitive. Good products and good positions will remain competitive, albeit potentially in different hands. The marginal players and positions will disappear.

The Problem

Over the past several months, demand in the U.S. has declined more drastically than at any point since World War II. Overall volume has contracted by 34 percent since last year, to a level not seen in 25 years; the mix between models—trucks and SUVs versus car-based vehicles—has flipped from a ratio of 55/45 to 45/55 in a matter of months. This is not your typical cyclical downturn, but rather a combination of structural factors that are unlikely to change anytime soon.

The simmering credit crisis reached the boiling point in September, with credit for all borrowers, both commercial and consumer, almost impossible to obtain. Oil prices reached the unimaginable high of nearly US$150 per barrel in July. As economies around the world, not least in the U.S., slipped into recession, already nervous consumers cut back on spending for the first time since the early 1990s, severely affecting spending in the auto industry.

These are events that few people could fathom just six months ago. Yet the extraordinary challenges the industry faces have only just begun. Every possible scenario calls for a restructuring that will fundamentally reshape the industry. What are the forces that are transforming the auto industry so rapidly? And what will it look like once the process is complete?

Reshaping Demand

The effects of the financial meltdown of 2008 on automobile demand have been unprecedented in terms of speed and magnitude. From 17 million units annually in the U.S., auto sales have swooned to below 11 million this year—and the outlook for 2009 is not much better. Global demand is falling as well: Western European sales are down by 7.5 percent from a year ago, and developing markets such as China and India are seeing their growth rates slow

to 5 to 7 percent, compared with 15 to 24 percent last year. Overall, global sales are down by about 3 percent and the outlook for 2009 is even lower.

The pre-downturn U.S. sales level of 17 million units annually was supported in part by the credit bubble created by the now-repudiated post-9/11 monetary policy. This time around, the strategy of easing credit will not come to the industry's rescue—supposing there was room to ease credit further. Even if monetary policy reduced overall interest rates to ease the economic pain in the near term, credit spreads are expected to remain high. Banks have become distinctly unwilling to lend, except at high rates and only to their most creditworthy customers.

OEMs' captive finance arms are also suffering under the burden of major, mostly as yet unrealized, residual losses and bad consumer loans. As their balance sheets weaken, their borrowing capacities shrink and their borrowing costs go up, further increasing the cost of providing consumer loans to prop up sales. Companies with less-than-stellar credit ratings—most notably the Detroit Three—are being hurt the most. Furthermore, the Federal Reserve is very unlikely to repeat its mistake of keeping interest rates at low, bubble-inducing levels once we pull out of the downturn.

Not only has total volume come down, but the product mix has shifted as well. Despite the steep decline in overall demand, sales of small cars have grown 3 percent over the past year and nearly tripled in volume over the past five years. Forecasts indicate that small-car sales will double over the next five years despite a continuing soft auto market. Even the startling declines in the price of oil in October and November won't lure consumers back to large, gas-guzzling vehicles anytime soon. Although the speed of the recent decline in prices at the pump has been remarkable—not to say a relief—it underscores the likelihood that prices will rise just as dramatically when the global economy recovers. Indeed, few people expect a sustained return to the low fuel prices the U.S. enjoyed from the mid-1980s until a few years ago. The days of cheap gasoline as a way of life in the U.S. are past.

Restructuring the Industry

Just as the decline in demand for new vehicles is historically unprecedented, so too will be the effects on the industry's structure. Within a matter of months, the industry landscape of OEMs, suppliers, dealers, and finance companies will be far different. Everyone will be affected, but the effects will be far from uniform. The near-term and long-term prospects among the various players vary greatly, and the differences in relative strength among competitors—both OEMs and suppliers—will be greatly magnified in the upheaval now irreversibly under way.

The downturn in the U.S. auto industry has already affected every single OEM in the market. Sales for even the strongest players, such as Honda and Toyota, have been almost as poor as for the Detroit Three. However, as the restructuring starts taking more definite shape, it will not affect the entire industry equally. The stronger players will rise to the top, while the weaker ones will weaken further, if they don't perish entirely.

The Detroit Three: The weaker players—most notably the Detroit Three—will bear the brunt of the restructuring, for reasons that are both financial and structural. When they encountered the demand precipice, they were already struggling to resize their operations to better fit a combined market share that had eroded by about 25 percent (or 20 share points) over the last decade. Their combined head counts, brand counts, assembly capacities, retiree commitments, and dealer networks had not yet been sufficiently scaled back to match the reality of their lower, and still declining, market shares—much less this violent downshift in demand. They are the ones with the most marginal assets, the least ability to reduce fixed costs in line with demand, the most damage from the shift to smaller vehicles, and the weakest balance sheets.

The differences between the strong and the weak are so great that a major restructuring of the Detroit auto industry into something much smaller, much leaner, and much more viable is inescapable. Government money and intervention may well affect how quickly the restructuring occurs and how controlled it is, but not its inevitability. Federal funding without radical restructuring will only postpone the reckoning. With the Detroit Three bleeding $4 billion to $5 billion in cash collectively every month, funding their excess capacity for a couple of years is simply not politically or fiscally practical for the U.S. government.

Whether it happens in a structured fashion or through acts of the market itself, capacity will come out. The only way any of these companies might survive is if they shrink rapidly to a much smaller, profitable core. This a defining moment: Weak OEMs must take this opportunity to completely restructure their businesses—right-sizing dealer networks, removing legacy costs once and for all, cutting and shifting product lines, exiting high-cost plants, redefining supplier networks, changing supplier relationships, and setting all contracts right. We could squander this opportunity to revive a major U.S. industry or recognize it as a chance to remake the industry into a stronger, if smaller, global player—as painful as the process will be.

Whether the Detroit Three becomes the Detroit Two or the Big One doesn't matter. What matters is that both Ford and GM need to take an objective view of what they will look like after the coming restructuring. What products, plants, and market positions will they occupy? Where can they be sustainably competitive? What smaller core business can they create that is truly viable and competitive over the long term? When reduced to the core, can they go it alone,

or do they need to combine with others to diversify globally and build the scale to invest in technology for tomorrow? And if they secure federal funding support, how do they use it to restructure? The answers to these questions should not be constrained by historical perceptions or current liabilities.

The Japan Three: The stronger players—and particularly Toyota, Honda, and Nissan—are both structurally and financially better positioned for survival. They entered the credit crunch with strong balance sheets: Toyota, for example, continues to maintain a strong balance sheet and a AAA credit rating, despite the tough times. The stronger balance sheets of these players—and their captive finance arms—provide a much lower cost of capital, which they can use to invest in innovation, even out sales, and support their dealers.

Over the long term, because their product mix is already geared toward smaller cars and their fleets overall boast higher average gas mileage, the lineups of the stronger players are already very much in tune with the way the global car market is trending—toward smaller, more economical cars. At the same time, their fundamental operating models and economics already give them significant competitive advantages: They can produce higher-quality cars at lower cost, and the profits earned thereby allow them to undertake the product development necessary to maintain those advantages. The fact that their burden of legacy costs—pension, healthcare, aging plants—is so much lighter than their older U.S. competitors' only strengthens their long-term economic advantages.

Yet they too will face real hurdles in a restructured world. Traditionally, Toyota, Honda, and Nissan have looked at each other as competitors and benchmarks for performance. But in reality, they have prospered by taking share from the Detroit Three, thanks to their lower costs and better value relative to Detroit. The U.S. has been their most profitable market by far, because Detroit controlled most of the market and owned the marginal capacity.

In contrast to the relentlessly steady gains of the past decades, the coming restructuring will result in a sudden boost in their collective market share. This actually may prove to be a difficult adjustment for these companies, because they will have to defend share rather than methodically take share over time. However, once this discontinuity plays out, the game will be changed. They will have to compete with stronger opponents—including each other. The shrunken Detroit One or Two will be a much smaller force, but a stronger one, and no longer a relatively easy target for poaching share. Other growing rivals, such as Hyundai, and over the long term possibly even Chinese players, will benefit from restructuring as well, and may well become even more formidable opponents. Overall, the post-restructuring U.S. market, featuring lower volumes and tougher competition, will be a more difficult world for the Japanese Big Three. Beyond hunkering down for the short term and waiting for

Detroit to shrink, they must make important choices now about how to thrive in this Darwinian world.

Suppliers: The Detroit OEMs' current downward spiral will inevitably have a domino effect on their suppliers. Unlike the OEMs' situation, however, suppliers' survival will not hinge solely on being one of the stronger players. Two distinct factors will determine the fate of suppliers in the coming restructuring. The first is simple: To what degree is the business dependent on the Detroit Three? The downturn in demand will likely take out as much as 30 to 40 percent of capacity from the Detroit OEMs, and this in turn will wreak havoc among suppliers dependent on them. Suppliers less dependent on Detroit will be in a stronger position: Their more globalized customer base, being less susceptible in the long run to the downturn in demand, will cushion the blow.

The second factor concerns whether the business has a significant, sustainable competitive edge, or whether it is just another player. Is there a real advantage in terms of cost, delivery, or technology? Does its scale or process technology give it a leg up? Does it offer some differentiated technology for which it can charge a premium? Is it positioned well for the technologies and products that will win in the next upturn?

It is these two factors that will sort the weak from the strong in the coming restructuring. If a company has no special advantage and it sells primarily to the Detroit Three, then its chances of survival are poor. If it can face that fact honestly, and soon, it may be able to slim down to a sustainable core, or just sell off those pieces of the business that others might want.

If the company has no particular sustainable edge, but does have a widely diversified customer base, then it will need to restructure quickly to weed out the least competitive operations and try to boost advantages in the more viable businesses.

Even if it has a significant competitive advantage, it's in trouble if it sells primarily to the Detroit Three. It needs to build on those advantages and diversify its customer base as fast as possible. The alternative is to sell out to a stronger competitor.

Obviously, the strongest suppliers are those with the best competitive position and a global customer base. They too will feel the effects of lower demand and the structural changes the industry is facing. And the increase in competition following restructuring will put increasing pressure on their margins. But if they can sustain their cost and technology advantages, they should be well positioned for the coming shake up.

As the Tier One suppliers go, so go the Tier Twos. They too must look to their customer base and their competitive advantages to judge how they will fare as the industry restructures. Consolidation among all the auto suppliers is inevitable; a company's role in that process depends on what it sells, and to whom.

The Global Advantage

The most important action every stakeholder in the auto industry must take is to think globally and beyond the immediate horizon. The causes of the current downturn demonstrate the degree to which every player is inextricably intertwined; this recession will be deep and long, and the ensuing massive restructuring will affect every company in every region around the world. On the other side of the recession will be an auto industry that has been transformed globally. Success in the upturn will require companies to understand the terms of that transformation—new technologies, new sources of demand and supply—and to act accordingly.

Scott L. Corwin
Partner
scott.corwin@booz.com

Evan R. Hirsh
Partner
evan.hirsh@booz.com