# Car Trouble: Should We Recall the U.S. Auto Industry?

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When Wharton management professor John Paul MacDuffie is asked to explain why General Motors and Ford continue to take a drubbing from their competitors, he thinks for a moment and replies: "You can dig into the particulars around products and manufacturing processes for an explanation, but I guess the broad impression is the U.S. companies don't tend to be good learning organizations, which is something Toyota and Honda are superb at."

Whatever the U.S. car companies have learned in the past year, they have learned it the hard way. Consider the opening sentence of GM's 2003 annual report, published 12 months ag "Here's what's new about GM's strategy this year: Nothing."

That's the kind of bold statement that can cut two ways. GM intended it to convey the message that the world's largest automotive company was firing on all cylinders in its attempt to reverse its declining fortunes, and saw no reason to change. Twelve months later, though, the boast rings hollow. On April 19, General Motors posted a first-quarter loss of $1.1 billion, its worst result since 1992. Just two weeks earlier, on April 4, chairman and CEO Rick Wagoner had announced a management shake-up that gave Wagoner the additional title of head of the corporation's unprofitable North American unit, a post he had held before becoming chief executive. In addition, GM's European operations are losing money, the ratings service Moody's recently downgraded GM's debt to one step above junk status, huge pension and healthcare liabilities have saddled the company with seemingly intractable fixed costs, and its stock has lost one-third of its value since January 1.

GM's trouble is not the only tale of woe in the auto sector. On April 11, Ford's stock was hammered after the company cut its yearly earnings forecast in half, and the shock waves from Ford's bad news affected the shares of several auto-supply companies. Later, on April 20, Ford announced $1.1 billion in net income for the first quarter, a 38% decline from a year earlier, and projected that it would either post a loss or just break even in the second quarter. In Germany, shareholders at DaimlerChrysler's recent annual meeting lambasted chief executive Jurgen Schrempp, who has presided over a 50% drop in the company's share price since Daimler and Chrysler merged in 1998. Shareholders were also angry about a fourth-quarter profit decline of 97% at Mercedes-Benz due to quality problems that were uncharacteristic of the blue-chip brand. In Britain, the once-renowned MG Rover car company went out of business April 15, putting some 5,000 people out of work. Meanwhile, Toyota and other companies in Japan and Korea are healthy and continue to grab market share from their U.S. competitors. And Chinese companies are waiting in the wings as potential exporters to give American, Japanese and European automakers one more thing to worry about.

What's going on? Auto industry experts at Wharton and elsewhere say the business has been undergoing wrenching fundamental changes for years but that the changes are accelerating. Recent troubles are only the latest examples of how U.S. firms are losing the battle to Toyota, Honda, Hyundai, Nissan (which has had an alliance with the French carmaker Renault since 1999) and European companies in what was once a U.S.-dominated industry.

It's true that U.S. companies in recent years have made great strides in closing the quality gap between


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their products and those of their competitors and in cutting costs. It is also true that they have tried with mixed results -- Cadillacs and SUVs are notable successes -- to produce cars that excite consumers. But the experts interviewed by Knowledge@Wharton say Detroit, for all its progress, has not yet done enough to halt its eroding market share. One chief shortcoming, they say, is that the Motor City simply does not make customers their top priority, too often sticking with tired models that they churn out with the hope that people will buy them. To regain market share and increase profitability, U.S. automakers must cut costs significantly, do all they can to produce products that people like, and improve the customer experience at the dealership level.

MacDuffie notes that Ford and GM each pursue a "near-term, profit-boosting strategy" that relies heavily on "hit cars" instead of a more fundamental, longer-term approach in which they work to have every part of the company function strongly. Detroit has been riding the minivan, sport-utility and pick-up truck crazes for so long that it has become overly dependent on these product lines for profitability and pays insufficient attention to other issues.

"Now there is all this talk in Detroit about the 'year of the car' [in an attempt to produce a sales revival]," according to MacDuffie, co-director of the International Motor Vehicle Program (IMVP), which is based at the Massachusetts Institute of Technology and has a network of researchers at universities worldwide. "Well, if you have spent the better part of a decade neglecting your car line in favor of your truck line, you are not going to bring out cars that compete well with the Toyota Camry, the Honda Accord and the Volkswagen Passat. Cars are the most complicated part of the marketplace and it's hard to just step back in."

### Closing the Quality Gap

J.D. (Dave) Power III is chairman of J.D. Power and Associates, a company that has done much to promote vehicle quality through its awards program. Power believes Detroit has learned a lot about producing quality vehicles -- so much so that quality, while still important, is no longer the major differentiator among U.S., Asian and European automakers that it once was. In years to come, Power predicts, the experience that buyers have -- or anticipate they will have -- at auto dealerships will replace quality as a deciding factor in making or breaking car sales.

Says Power: "One of the big differentiators now and for the next five years or so will be at the retail level: how the customers are being treated, both at the time they are buying cars and through the ownership experience of having the cars serviced and maintained by the retailers. That's where we see a lot more variation from one dealer to another."

Power goes on to explain that young people, by demanding more of automakers and auto dealers than their parents and grandparents did, will push the industry to keep making improvements. "The older buyers like myself [in their 60s and over] have seen such improvement over time that we think things are great. But the new buyers' expectations are even higher. The manufacturers have to cater to a wide range of expectations, and the youth market is where they are finding the toughest job."

John Moavenzadeh, executive director of IMVP, agrees that U.S. carmakers no longer suffer the stigma of making rust buckets but notes that quality will remain a concern among all carmakers. He points out that the Ford Explorer suffered from bad publicity over the Firestone tire issue in the 1990s. More recently, even Mercedes learned that it is not immune to gremlins under the hood. Mercedes in April announced a recall of 1.3 million cars after it had trouble getting sophisticated electronic and software components -- that control everything from windows to music -- to work together.

Computer chips are so prevalent in vehicles these days -- luxury autos can easily have 200 or more -- that they can interfere with one another's functioning. One of the recent problems with Mercedes involved this kind of complexity: Drivers of some cars found that if they pushed a certain button to control the navigation system, their seats moved. Moavenzadeh predicts that quality problems will continue to irritate consumers in years to come as manufacturers install more complex computer systems.


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### The Customer Should Be King

Another researcher at IMVP, Matthias Holweg, a lecturer at the Judge Institute of Management at the University of Cambridge in England, believes that U.S. automakers can learn a lot from European companies. He says the automakers that will come out on top in the industry's second century will not be those that opt for larger and larger scale (an approach that Wagoner has said GM must pursue) or achieve efficiencies on production lines. In a book titled, *The Second Century: Reconnecting Customer and Value Chain through Build-to-Order*, Holweg and co-author Frits K. Pil of the Katz Graduate School of Business at the University of Pittsburgh argue instead that manufacturers will lose ground unless they design and build vehicles as if customers really mattered. In their view, that means building cars to order, as European companies often do.

"The auto industry is still using the same techniques as it did to build the Model T in 1908," according to Holweg. "We have come a long way in refining the product, but there has been no drastic change in manufacturing. Everyone makes boxes. We sell cars the same way as Henry Ford. This old-style, mass-production thinking is causing so much of the problems in Detroit at the moment."

Most car companies continue to hold the view that having factories running at 100% capacity is the most efficient way to produce vehicles because it allows the manufacturer to minimize the cost to produce each unit. Indeed, overcapacity has long been cited as a problem for automakers worldwide: According to *The Economist* magazine, factories are capable of producing 80 million cars and light trucks a year but actually churn out only 60 million. But, in the view of Pil and Holweg, the problem with this volume mentality is that it is not enough to generate sustainable competitive advantage. Each year far too many vehicles are left unsold. To clear out inventory, manufacturers are then compelled to offer millions of dollars in incentives in the hope that customers like the price enough to settle for a car that was not their first choice.

"People want individual, customized products," according to Holweg. "If you look at why Renault and VW are profitable while Ford and GM aren't, it's because they do listen to customers." Holweg says that 55% to 60% of all cars sold in Europe are built-to-order, compared with only 5% in the United States. "The sad thing is that half of U.S. buyers compromise and one-quarter of European buyers compromise on features. The three most critical items for consumers are exterior color, engine size and the type of radio. [Satisfying consumers] is not a difficult thing for companies to fix. Two-thirds of U.S. customers say they'd rather wait up to three weeks if the car is the right color. Customers do know what they want."

### The China Market

Major automakers form Europe and the United States have long had a presence in China, engaging in joint ventures with Chinese companies (as is required by Beijing) to sell cars in that burgeoning market. But, before long, those same automakers will see China become an exporter of vehicles to the United States, Europe and other markets. It remains to be seen how significant a role Chinese automakers will play. But Malcolm Bricklin is one U.S. businessman who is banking on China being able to produce quality vehicles at low prices that will be in demand by Western consumers.

Bricklin, an entrepreneur who has brought two well-known car brands to U.S. shores -- the well-thought-of Subaru and the much-maligned Yugo -- now is making plans for his company, Visionary Vehicles, of New York, to import cars made by Chery Automobile of Wuhu, China, by 2007. They would be the first Chinese cars ever exported to America.

"The major [U.S.] manufacturers are stuck with all sorts of problems that they can't get out of easily, from [unwanted] cars to health care costs," says Bricklin. "That is going to kill them." Chinese car companies, on the other hand, are doing well despite a recent slowdown in sales, and in a few years' time most will be ready to ship quality, affordable cars abroad, according to Bricklin. "They will be going though a learning


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curve that will probably take four or five years. But Chery is ready to go; two years from now they will be ready to export."

Bricklin expects to sell 250,000 Chery vehicles in the United States the first year. He says the cars will rival luxury products like the BMW or Lexus in quality but cost much less. Bricklin's is an ambitious sales target that no auto exporter to the United States has ever achieved. But Bricklin is confident that consumers will give his cars consideration if it can be shown that they are well made. "The cars will be reviewed [by auto publications]," he says. "If we live up to what we say we're going to do, we think [people] will take a test ride. . . . You can't ever bring cars in again that are not top quality. We know if you can give value for a good price, Americans will at least check them out."

Efraim Levy, an auto analyst with Standard & Poor's, says there is no reason why Chinese companies cannot eventually produce cars for export, noting that Korean firms have made great strides in recent years. "I think down the road we will likely see Chinese cars sold in America. . . . Look what Hyundai did. They started slow but offered 10-year warranties to back up their [quality] claims, and they are gaining making share in the U.S."

Wharton's MacDuffie agrees that Chinese companies will be players in the world auto market. "There already is a lot of good engineering talent in China, and there is a real desire on the part of the government to develop a strong auto industry."

But, citing the experience of Korean companies as an example, MacDuffie warns that the Chinese effort may not go smoothly. Hyundai, for instance, shipped its first model to Canada - its initial North American foray -- in the 1980s. Within a year, Hyundai had captured 10% of the Canadian market with a car called the Pony. When the Pony was introduced in the United States under the name Excel, it sold like hotcakes. Hyundai felt confident enough to build a plant in Canada. But several years later, when the cars developed rust and other quality problems, there was a huge downturn in sales and a negative quality image got attached to Hyundai vehicles. Then, in the 1990s, Hyundai exported more cars to America. Their quality was somewhat better and the prices were attractive. But a spate of labor unrest hurt product quality once again. Eventually, Hyundai vowed that it would work tirelessly to match the quality of Japanese cars, and it is making progress toward that goal. The Hyundai Sonata was ranked highest in the 2004 J.D. Power Initial Quality Study of the entry midsize car segment, ahead of the Chevy Malibu and Pontiac G6.

"That's a stunning achievement, but is it sustainable?" asks MacDuffie. "If it sticks, Hyundai will be a very serious competitor. So, Korea's story could be China's story: People might flock to Chinese cars at first, but if they have quality problems, that could create a negative image and hold them up for a few years. However, I think China's ambition will take them over all those hurdles, and some Chinese companies will be competitors in this very competitive world market. It won't happen overnight; maybe one step forward, two steps back."

As for Ford and GM, a lot of hard work lies ahead -- not to establish brands and reputations but to sustain them. "They are clearly facing challenges," says S&P's Levy. "Can they turn it around? First, they have to stem the loss of market share. The way to do that is come out with products that customers want. . . . You can't cost-cut yourself to growth. Right now, they're going to refresh their pickups and SUVs at the beginning of 2006. Hopefully, that will be enough to put them back on track. But with gasoline prices rising, their timing may be off."

Power says global competition is so fierce that Detroit may have to become accustomed to being a smaller player. "There is a structural situation that is going to make it very difficult for GM and Ford to keep from losing market share, and they have to be looking at trimming down their operations. They have got excess capacity and excess overhead, and some of it they can't get rid of overnight, like the pension liability and the health care costs. Those decisions were made 10, 20 years ago. Perhaps there's more opportunity for them overseas than their home market."


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