Auto Industry Consolidation: Is There a New Model on the Horizon?

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The turmoil and uncertainty among auto manufacturers and their suppliers have left people wondering when a shakeout can be expected. Two experts who follow the auto sector say consolidation will take place among suppliers to a much greater extent than among carmakers, which may not experience mergers and acquisitions at all in the near term but will be engaged in ever-shifting strategic alliances and joint ventures.

In particular, some private-equity firms are hungrily eyeing auto supply companies for investment opportunities, according to Wharton management professor John Paul MacDuffie and Christopher Benko, director of the PricewaterhouseCoopers Automotive Institute in Detroit.

The comments by Benko and MacDuffie come as the industry is staging the 2006 North American International Auto Show in Detroit. The show has an odd feel to it this year. Manufacturers are using the glitzy venue to unveil sleek new products that they hope will get consumers excited, but the show is also focusing attention on the much-discussed difficulties facing companies like General Motors and Ford, as well as parts supplier Delphi, which filed for protection under Chapter 11 of the U.S. Bankruptcy Code last year.

"There are a number of issues weighing this industry down, but the fundamental point is that the drivers of change are less connected to cyclical factors, and are more a function of structurally embedded problems that this industry has been avoiding for some time," says Benko. The industry, he adds, is not going to grow its way out of its problems. North America and Europe are mature markets, and while there are opportunities for growth in emerging markets, those opportunities are still in their nascent stages.

"We have business models that no longer work," Benko adds. "This is putting the viability of many companies into question. Plus, you have a changing of the guard taking place, as new leaders are emerging.... The industry needs to be restructured, and we are on the cusp of an era which will have more clearly defined winners and losers."

Alliances and Joint Ventures

Benko suggests that while there may be some automaker restructurings leading to changes in relative positioning, the major automaker lineup will remain largely intact over the next decade. Today's "Global 10" automakers -- Toyota, GM, Ford, DaimlerChrysler, Honda, Hyundai, BMW, Volkswagen, PSA and Renault-Nissan -- will probably still be around in 2016. But what is likely to happen is that some automakers will be forced to rethink their global market positioning and engage in more targeted alliances and joint ventures as they take steps to adjust to market challenges. Any number of such combinations has already occurred since the 1990s.

The weaker automakers are more likely to shrink than disappear, according to MacDuffie, who is also co-director of the International Motor Vehicle Program, a network of researchers at universities worldwide that receives funding from major automakers and suppliers. "Most of what we're talking about -- even with the troubles at GM and Ford -- are very big companies potentially shrinking to become smaller companies," MacDuffie says. "Regardless of where people stand on the issue of whether GM will

go into bankruptcy, they all expect GM to come out of bankruptcy and continue to function. In that sense, there are no companies that look so weak that they would disappear."

Neither MacDuffie nor Benko would say whether GM will -- or should -- file for bankruptcy, but both say any troubled automaker would do all it could to avoid that step, both as a matter of pride and out of fear that such a move would spark a sharp decline in sales. It is true that consumers have become accustomed to, say, airlines continuing to operate while reorganizing under the supervision of a bankruptcy judge, but people's willingness to buy a ticket from a bankrupt airline is different from their willingness to buy a car from an automaker in Chapter 11.

"Chapter 11, in itself, doesn't have the stigma it used to," Benko says. "Most people know it has become a tool to restructure a business. But a car company going bankrupt may differ from an airline. People don't have a long-term vested interest in an airline except for frequent-flier miles. They know airlines are in bankruptcy right now, but they still fly bankrupt carriers. Buying a ticket is a short-term transaction. But consumers may feel differently about a car company going bankrupt. They worry about long-term service and warranties and parts. Traditionally, automakers have done whatever they could to avoid Chapter 11, if just from a public relations perspective."

Benko and MacDuffie agree that the coming shakeout among companies that supply components to automakers will be significant. Benko notes that many subsectors remain fragmented, with too many overlapping (and often unprofitable or barely profitable) suppliers. After the restructuring, he says, there will be larger, more globally oriented suppliers with better portfolios of business that can leverage scale and sustainable research and development capabilities to bring products to their customers to help them maintain or increase market share. That, however, will only happen after a painful shakeout period among parts suppliers.

"We are at the beginning of the shakeout already," notes Benko. "Supplier profit margins are absolutely razor thin. In many cases, they are losing money on products. Making it up on volume doesn't work. A spike in commodity prices of steel and plastic put enough pressure on the supply chain that a number of suppliers became non-viable within a matter of days or weeks. The number of components companies filing for Chapter 11 spiked in 2005. Those closest to commodity pricing pressures were the most exposed and could not make it."

The 'China Price'

According to MacDuffie, many Western parts suppliers are under immense pressures from lower-cost Chinese parts producers and need to consolidate to strengthen their chances of survival. "The 'China price' is one of the buzzwords you hear now. "Automakers call their suppliers and say, 'What are you going to do to meet the China price?' Every supplier is facing those demands."

Some suppliers that have already consolidated ran into trouble by combining for the sake of scale instead of sound strategic reasons, taking on huge amounts of debt in the process. This, in turn, placed even more pressure on the combined companies. The idea of the market having fewer suppliers that are more global in nature remains a sound one. But suppliers today have neither the cash nor the stock to use as currency to continue the necessary consolidation. That offers opportunities for private-equity firms to enter the picture and accelerate consolidation by buying up weakened companies.

"Private-equity firms are looking for undervalued assets to acquire," Benko says. "The industry, however, often resists private equity. Private-equity operated companies take a dispassionate view of business and tend not to genuflect at the altar of auto companies the way traditional suppliers often do. A very symbiotic -- but dysfunctional -- relationship has developed between suppliers and carmakers."

Benko adds that the amount of money going into private-equity funds these days is enormous, but such

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investors typically are not focused on the auto industry. Since there is not a lot of demand for struggling parts companies, prices will not be bid up very high and the number of private-equity firms that end up changing the nature of the supplier sector will be few in number. "You will see a small number of well-capitalized investors who will look for troubled companies within specific sectors, buy them, fix them up, sometimes combine them, and then look for an exit strategy."

One private-equity investor who has shown an interest in buying parts suppliers is billionaire investor Wilbur Ross, chairman of WL Ross & Company, New York. Ross, 68, is well known for purchasing distressed steel companies Bethlehem Steel and LTV, improving them, and selling them at a profit. In 2004, Ross sold International Steel Group to London steel magnate Lakshmi Mittal for $4.5 billion. Ross himself pocketed $300 million from the sale, according to *U.S. News and World Report*, but one union official credited Ross with not only saving jobs but saving the U.S. steel industry. More recently, Ross's name was in the news following an explosion at a coal mine in West Virginia that killed 12 miners. International Coal Group, owner of the mine, is a conglomerate created by Ross from ailing coal companies.

Wary of Debt

MacDuffie says Ross may succeed where the parts suppliers themselves have failed at consolidating themselves and reversing their fortunes. "The biggest strategic difference Ross himself talks about is he thinks earlier companies blew it by loading up on so much debt that the slightest speed bump in demand from customers left them facing problems. His goal is not to load up on debt, and that's a pretty big difference. If he acquires companies coming out of bankruptcy when debt has already been reduced, there is a nice possibility for him to do something different. He's got good timing and a lot of resources to invest."

Talk of restructuring among auto-parts companies is not new; parts-makers Delphi and Visteon are spin-offs from GM and Ford, respectively. In the 1990s, research by MacDuffie shows, between 700 and 900 different suppliers were selling car and truck parts to each vehicle assembly plant in North America and Europe. By 2001, the number of suppliers to each plant had been cut to about 450. In the fall of 2005, GM and Ford announced new plans to further reduce the number of suppliers with whom they do business.

But consolidation simply to create bigger companies will not, by itself, guarantee that parts suppliers will succeed, nor will the once-hot idea of ever-bigger suppliers making modular sub-assemblies to speed up the production process at automakers' factories. The car business has been resistant to the increasing use of modular components, MacDuffie explains. It is true that suppliers have shifted from focusing on small components to making larger sub-assemblies, which simplifies the job for workers on the auto assembly line. But modules are not always standard across the industry and sometimes not even across car models in the same company.

"The view that big suppliers can be successful still exists there despite failures and uncertainties," MacDuffie says. "Some have done well, and others have not. You can't generalize."

As carmakers pressure parts suppliers to reduce costs, they run the risk of causing long-term harm to their own business of selling cars. If suppliers lack sufficient capital to invest in research and development to continually improve their products, automakers will suffer. "Given the competitive intensity of this industry, if your products aren't innovative, you won't attract consumers," warns Benko. "Given today's business model, the current price war is undermining the domestic automaker's ability to fund their R&D."

The price war that GM, Ford and Chrysler have been waging can be ruinous for several reasons. Deep price cuts, in the form of incentives, eat into profits. Incentives also condition customers to hold off buying cars until the next incentive program is announced. GM took a step to combat this problem on January 10 when it announced plans to reduce prices on most models. By shifting away from incentives,

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GM hopes to smooth out customer demand. A Ford spokesman welcomed the move, saying it can benefit the industry as a whole by helping to firm prices.

But the effect of GM's move will not be known for some time, which means carmakers remain mired in a vicious cycle of slashing supplier costs and slashing vehicle prices, while trying at the same time not to erode the vehicle quality they have worked hard to achieve in the last 20 years -- which is why the industry is ripe for consolidation.

Says Benk "Even if the overall automotive market holds up this year, this is an industry that has little room for error. Anything that accelerates change in market share between the major automakers will accelerate that restructuring. So 2006 could easily be the year when you see some of this cleansing process start to take place."

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