

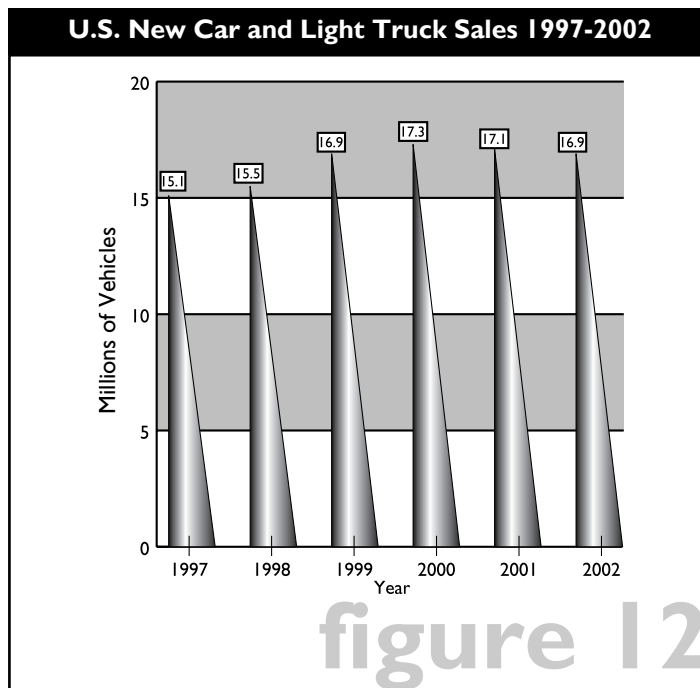
# THE ROAD AHEAD FOR THE U.S. AUTOMOBILE INDUSTRY: CHALLENGES OF A SLUGGISH ECONOMY

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In a report released in 2002, the U.S. Department of Commerce's Office of Automotive Affairs outlined the turmoil confronting the industry in recent years, even noting that "the year ahead will be filled with painful adjustments for some manufacturers," while concluding with the more salutary expectation that "as it has been for over a century, the automobile industry will continue to function as an engine of economic wealth for the nation."<sup>56</sup> In exploring the rationale for the difficulties confronting the industry, undoubtedly, the sluggish nature of the U.S. economy remains the principal contributory factor. The 2001 recession, coupled with the September 11 terrorist attacks and the pervasive uncertainty caused by conflict in the Middle East, the potential for further terrorist attacks and several other structural issues, has prevented the economy from gathering momentum and surging ahead. Consequently, like so many other sectors, the automobile industry has been negatively affected by the dragging economy. The industry has been mired with diminished automobile sales prompting layoffs at both the manufacturing and retail ends of the industry.

A statistic in the industry that is carefully monitored and eagerly awaited each month involves new car and light truck (non-commercial) sales. Figure 12 documents these sales figures for the 1997-2002 period for the United States as a whole. The decline in 2001 capped a five-year uninterrupted growth track of progressively higher sales volumes that culminated in 2000, with 17.3 million vehicles sold, the highest sales level ever. The decline between 2002 and 2001, of 1.5 percent, followed the slightly smaller decline between 2000 and 2001 of 1.2 percent. In addition to the annual figures, more recently, in August 2003 (the latest month available in third week of October 2003), federal figures note that 11.3 million new cars and light trucks (non-commercial) were sold.

In terms of the specific breakdown of companies selling new cars and light trucks in the United States, Detroit's Big Three (GM, Ford and Chrysler) experienced some setbacks given the downturn in the economy. In an effort to boost sales, the Big Three launched an ambitious raft of financial and other incentives in the aftermath of the September 2001 terrorist attacks and the



Source: U.S. Department of Commerce, Office of Automotive Affairs

faltering economy. While October 2001 sales were the best ever in American automotive history, the Big Three continued to offer even more attractive incentives for months thereafter.<sup>57</sup> These incentives took the form of 0% financing, i.e., interest free loans, and \$2,000-\$3,000 cutbacks in the price of these new vehicles as the Big Three opted to endure plunging revenues as opposed to losing sales. Yet, the Big Three can ill afford to continue hemorrhaging cash in an effort to garner more sales, and it is expected that these incentives will begin to diminish.

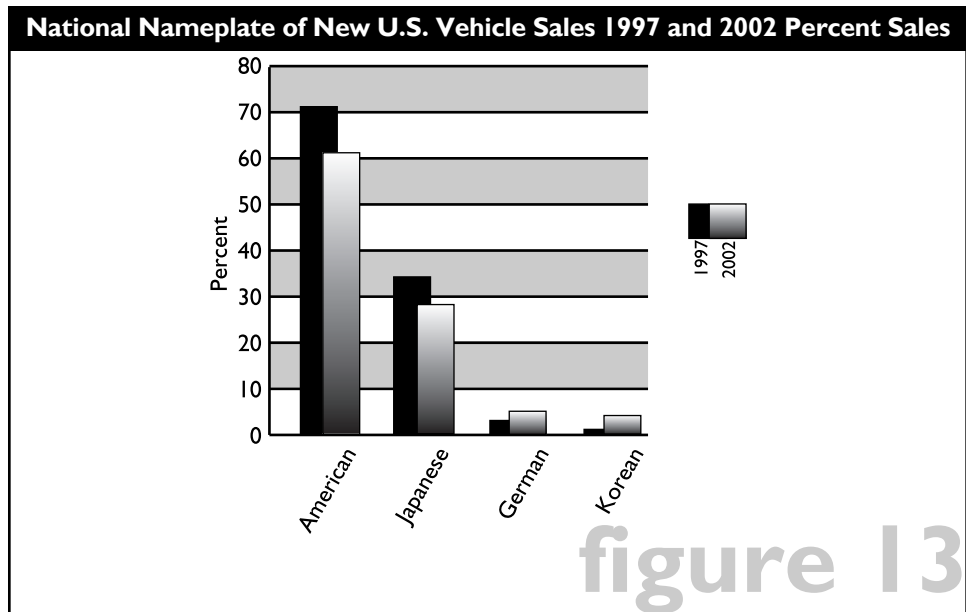
It is appropriate to review the Big Three's sales figures for the most complete, recent year (2002) and October 2003. These data provide greater perspective in drawing certain conclusions about the challenges confronting the industry.

- » In 2002, the Chrysler Group sold 2,205,446 vehicles, compared to 2,273,208 in 2001, a decline of 3 percent. During this latest year, Jeep brand sales were 459,796 vehicles, an increase of 1 percent compared to the prior calendar year 2001. Similarly, the Dodge brand had sales of 1,264,782 units, an increase of 1 percent compared to calendar year 2001.<sup>58</sup> At the end of October 2003, the Chrysler Group reported sales of 166,262 units, an 11 percent increase from October 2002.<sup>59</sup>
- » General Motors delivered 4,858,705 new vehicles in calendar year 2002, down a modest 1 percent compared to the previous calendar year. In addition, the more than 473,000 new cars and trucks sold by GM in the month of December 2002 represented a 36 percent increase over December 2001 and was the highest since 1979. GM's truck and SUV sales set an all-time record in 2002, with Chevrolet trucks, GMC trucks, Cadillac trucks and HUMMER sales all performing exceedingly well. In particular, GM's HUMMER H2 is one of the best selling vehicles in the country.<sup>60</sup> In October 2003, General Motors dealers sold 363,043 new cars and trucks in the United States, down 7 percent compared to a year ago.<sup>61</sup>

- » In 2002, Ford sold 3,623,709 new cars and trucks, an 8.8 percent decline in comparison to calendar year 2001. Yet, Ford's December 2002 sales' record was impressive and represented an 8.2 percent expansion over December 2001 levels. Once again, in 2002, Ford's best selling truck, the Ford F Series, was America's best selling vehicle for the 21<sup>st</sup> year in a row with sales exceeding 800,000 vehicles for the fifth consecutive year.<sup>62</sup> U.S. customers purchased or leased 282,468 cars and trucks from the Ford group (Ford, Mercury, Lincoln, Jaguar, Volvo, and Land Rover) in October 2003, down 2 percent compared with a year ago.<sup>63</sup>

While the Big Three continue to see their profit margins erode, given dwindling sales and the increasing cost of incentives offered to consumers, several foreign automakers face a more encouraging scenario. For instance, boosted by strong sales in North America, Japanese automaker Honda Motor Corporation reported that its profits rose 9.4 percent in its fourth fiscal quarter, closing the fiscal year with record earnings for the second straight year.<sup>64</sup> Then, in late September 2002, Hyundai Motor America, on a sharp rebound since dealing with a quality problem with its cars, announced that it intends to sell 1 million vehicles a year in the United States by the end of the decade, a tripling of its current pace.<sup>65</sup> In early August 2003, the South Korean automaker announced that on the strength of cars and trucks sold in the United States, its second quarter earnings in 2003 soared to \$483 million, an 86 percent jump from the same period the previous year.<sup>66</sup> Similarly, for the same period in 2003 (second quarter), Toyota's earnings reached \$1.9 billion, while Honda reported \$850 million, all levels that dwarfed those of Detroit's automakers. Another foreign automaker, Nissan, under the helm of chief executive officer Carlos Ghosn since 1999, announced in April 2003 that it had wiped out all its debt (some \$19 billion in 1999) alongside posting a 33 percent increase in profit in 2002.<sup>67</sup> Based on these 2002 figures, Nissan achieved another one of its goals, reaching an operating profit level of at least 8 percent (Nissan secured an auto industry-leading 10.8 percent in 2002) and is working on selling at least 1 million new vehicles in the United States by the end of 2004.

Notwithstanding the continued dominance of the Big Three in America's new vehicle sales, several major challenges loom ahead. On the one hand, as expressed in figure 13, there is a decline in the number of new vehicles sold and on the other hand, the Big Three face increasing competition from the growing number of foreign automobile manufacturers that continue to both import a greater number of cars into the United States and also manufacture their vehicles at U.S.-based assembly plants. As demonstrated earlier, there has been a steady slippage in Detroit's share of the domestic automobile market: in 1996 the percentage breakdown was 73 percent Detroit and 27 percent foreign<sup>68</sup>; by 2002, this proportion had shifted radically to 61 percent Detroit and 39 percent foreign. Figure 13 provides this breakdown between 1997 and 2002.



Source: U.S. Department of Commerce, Office of Automotive Affairs

As indicated in figure 13, Detroit's share of new car and non-commercial light truck sales declined from 71 percent of the total number in 1997 to 61 percent in 2002. In contrast, the sale of Japanese, German and Korean vehicles, the three major foreign vehicles sold in the United States, all increased with the Japanese share expanding from 24 percent to 28 percent; the German share increasing from 3 percent to 5 percent; and, finally, the Korean share growing from 1 percent to 4 percent. Hence, dealing with this foreign competition will remain a serious challenge to Detroit's Big Three automakers in the coming years. In fact, as noted by *The Economist*, "[I]ncreasingly, Toyota Camrys, Honda Accords and Volkswagen Jettas rule the roads. California and other Pacific coastal states have long preferred foreign brands (albeit now mostly manufactured in America). Now, New England, New Jersey and Florida are going the same way."<sup>69</sup>

In addition, projections from experts in the industry indicate that auto sales will decline in 2003, to between 15.9 million and 16.2 million from the 16.8 million reached in 2002.<sup>70</sup> Hence, the expected decline in auto sales will increase the intensity of competition among all automakers to sell new vehicles, an additional pressure point for Detroit's Big Three alongside the long-term trend of a diminishing share of the total market. Hence, analysts stress that automakers will have to add new features to their vehicles and collaborate more with suppliers to control costs if they seek to boost their profit margins. In this realm, analysts maintain that customers will have to be induced into buying a new vehicle with features that were not included in the previous year's model, a completely revamped model and crossover vehicles such as SUV features on a car frame.<sup>71</sup>

As noted, the sluggish economy has resulted in a range of incentives, financial and otherwise, offered by Detroit's automakers to lure consumers to purchase new vehicles. Yet, while these incentive packages helped stave off even more significant sales declines, the Big Three have seen drooping sales and probably will see even more declines for the rest of 2003. Inevitably, the flood of financial and other incentives offered by the Big Three will consume an increasing portion of their already diminishing profit levels. In terms of the slate of incentives offered recently, analysis from the Detroit-based CoMerica Bank indicates that it took 19.9 weeks of median family income to buy the average new vehicle in November 2002, a week less than the start of the year

and the lowest since 1978.<sup>72</sup> table 13 provides more insights into the deals offered by the Big Three to entice would-be car and truck buyers to purchase their vehicles.

<b>Automobile Incentives and Monthly Selling Rates (Annualized)</b>				
<b>Month</b>	<b>2003</b>		<b>2002</b>	
	<b>Incentive Value</b>	<b>Monthly Selling Rate (Seasonally Adjusted in Millions)</b>	<b>Incentive Value</b>	<b>Monthly Selling Rate (Seasonally Adjusted in Millions)</b>
March	\$4,428	16.2 million	\$3,982	16.7 million
April	\$4,733	16.5 million	\$4,019	17.3 million
May	\$4,400	15.8 million	\$3,681	16.0 million

Source: "Automakers Prepare to Sweeten Already Tasty Deals," *USA Today*, May 29, 2003

As indicated, there has been a steady increase in the amount of incentives offered by automakers in their quest to protect sales from falling to intolerably unprofitable levels. As a quick comparison, in March 2002, incentives averaged \$3,982; a year later in March 2003, they increased to \$4,428. Similarly, in May 2002, they averaged \$3,681, while they expanded to \$4,400 by May 2003. Over the long term, the Big Three are averaging almost \$3,000 per vehicle in incentive costs, compared with \$1,861 in 2000. Asian automakers, in contrast, offered incentives worth \$1,045 on average last year, while European automakers offered an average of \$1,627 in incentives.<sup>73</sup> In fact, incentive costs are soaring, especially for the Big Three, in a weakening market overflowing with historic numbers of unsold cars and trucks.

<b>Average Incentive Per Vehicle</b>	
»	General Motors = \$3,675
»	Ford = \$3,219
»	DaimlerChrysler = \$3,059
»	European Automakers = \$1,945
»	Korean Automakers = \$1,371
»	Japanese Automakers = \$1,062
Source: "Incentives Drive Auto Sales," <i>The Atlanta Journal Constitution</i> , July 23, 2003	

It should be noted that the impressive inroads into the U.S. automobile market made by foreign automakers have largely occurred devoid of the costly incentives extended by U.S. automakers, a trend that does not bode well for the Big Three. In sum, not only have these foreign automakers seen their share of the overall U.S. market increase, they have been able to capture this greater market share without sacrificing a greater portion of their profit margins.

The following table presents data on the profitability and productivity of automakers in 2002 over the prior year. While there have been some improvements among the Big Three, they still lag the foreign automakers in the country on these measures.

### Profitability and Productivity of Major Automakers 2001 to 2002

Automaker	Profitability		Productivity	
	Per Vehicle	% from 2001	Hours to Build Vehicle	% from 2001
General Motors	+ \$701	1	24.4	+ 108 %
DaimlerChrysler	+ \$226	Note 1	28.0	+ 9 %
Ford	- \$114	Note 2	26.1	+ 3 %
Nissan	+ \$2,069	+ 61 %	16.8	+ 3 %
Honda	+ \$1,581	- 5 %	22.3	- 13 %
Toyota	+ \$1,214	+ 3 %	21.8	0.03

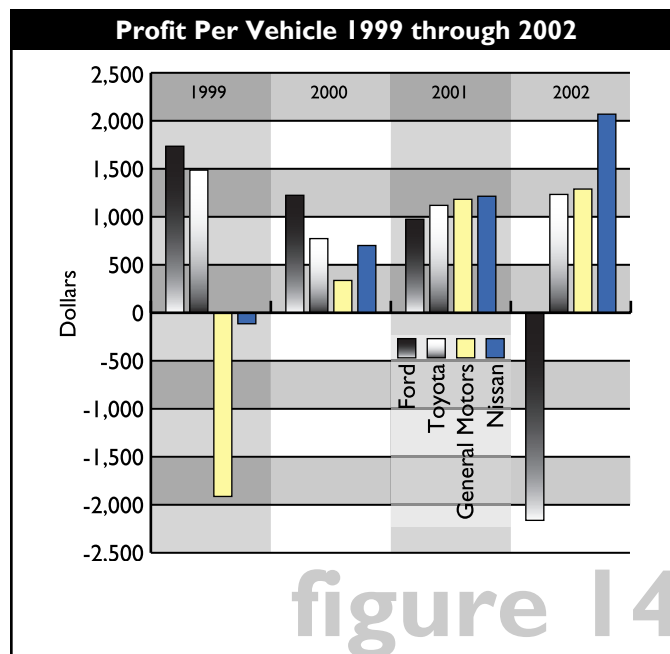
Source: *The Harbour Report North America 2003, The New York Times*, June 19, 2003

Note 1~DaimlerChrysler suffered losses in 2001; its loss per vehicle was \$1,679.

Note 2~Ford also suffered losses in 2001; its loss per vehicle was \$1,913.

While this report revealed encouraging news for American automakers, the lethal combination of slimmer market share in a shrinking market and rising incentive costs continued to widen the gap between domestic automakers and Japan. Yet, General Motors continued to make impressive strides toward bridging the productivity gap with Japanese automakers. Furthermore, the Chrysler Group of DaimlerChrysler, “the least productive of the six largest automakers in North America, had the industry’s best year-over-year improvement in 2002.”<sup>74</sup>

In terms of profitability, figure 14 demonstrates the difficulties faced by two of the Big Three in comparison to two Japanese automakers for the past four years (1999 through 2002).



Source: “Profit per Vehicle,” *The Mississippi Clarion-Ledger*, June 19, 2003

A decline in auto sales not only hurts automakers, it negatively affects auto suppliers too.<sup>75</sup> Hence, auto suppliers like Delphi (the world's largest auto supplier with \$27 billion in revenue in 2002, and ranking 67<sup>th</sup> in the most recent Fortune 500 listing), American Axle and Manufacturing Holdings (which depends on General Motors for most of its business), Visteon (a major parts supplier to Ford), Metaldyne Corporation (the consolidation of the former MascoTech, Simpson Industries and Global Metal Technologies), Lear Corporation, Johnson Controls, and Collins & Aikman all have experienced the downside of dwindling auto sales. Interestingly, Lear Corporation and Johnson Controls, sizable suppliers of dashboards, seats and other parts of car interiors, have been shielded from the recent sales drops to an extent because they perform much of their work for Asian and European automakers. In the context of auto manufacturers promptly looking to parts suppliers for cost reductions—70 percent of a vehicle's cost comes from pieces supplied by outside manufacturers—the pressure on these auto parts suppliers will be substantial in the coming months.