2011 Automotive Industry Perspective

After an unprecedented downturn, the North American automotive industry is beginning to recover. Industry volumes are expected to approach 12 million units in the U.S., far below the peaks of a few years ago, but well above trough volumes. The dislocations of bankruptcy and restructuring are mostly behind us, credit is becoming more readily available, and many observers expect demand to grow as the cars already on the road age.

Long-term industry fundamentals are improving now that the Detroit Three have greatly reduced legacy costs and are introducing more competitive passenger vehicles. Ford and General Motors are solidly profitable, and GM’s recent IPO raised roughly US$23 billion, placing its government investors on a path to recover much of their money. Further, Toyota appears to be recovering from its recall crisis, and Hyundai is gaining market share with an impressive line of new products.

By and large, suppliers are enjoying a similar turnaround. Several large Tier Ones have emerged from Chapter 11, and some suppliers are benefiting from the revival in industry volumes and improved product portfolios, which are generating solid profitability and cash flow. As a result, private equity firms that invested in suppliers at distressed prices are beginning to monetize the value that has been created through restructurings and improvements in automobile sales.

Yet, despite this good news, automakers and suppliers in North America still face significant obstacles to achieving sustainable profitability over the long term. In this letter, we share our perspective on the very real challenges still confronting the auto industry in 2011 and beyond. And we offer a series of steps that automakers and suppliers should consider to navigate these challenges successfully.

The Roadblocks

Though 2010 was a much better year than 2009 for most original equipment manufacturers (OEMs), significant challenges remain. Competition is fierce across most segments, as all of the manufacturers in North America are fighting to maintain or increase their “fair share” of the U.S. market, even
though it is operating at lower volumes than historical replacement cycles. Parts of the market, especially the small car segment, have pricing that makes it difficult for all but the most efficient companies to make money. Nonetheless, North America still remains one of the most attractive global markets for manufacturers.

Toyota, Honda, and Nissan are all adapting to tough competition from Hyundai in the U.S., where the South Korean automaker has launched a compelling lineup at attractive prices, which are supported by its efficient, low-cost U.S. manufacturing operations. Honda is fighting back with aggressive lease deals on its aging Accord. Toyota faces the problem of reestablishing its reputation for industry-leading quality and is using incentives to maintain share and volume.

For the Detroit Three, there is a separate set of obstacles. GM, Ford, and Chrysler still confront the difficult task of closing the cost gap with advantaged global competitors. Although union concessions sharply diminished health and pension legacy expenses, wages and benefits for current hourly workers are still well above benchmarks established by new North American plants (by more than $25 per hour for some labor categories). In addition, the unions are working hard to reverse recent concessions, which could erase hard-won gains.

The Detroit Three also have a quality perception gap to overcome. While the initial quality numbers for U.S. automakers and their Japanese counterparts are closer than ever—for example, Ford is now in the top five in the J.D. Power and Associates Initial Quality Study—car buyers may take as long as 10 years to catch up to the quality data, according to Booz & Company research. Until that happens, the Detroit Three will generally face unfavorable price–volume trade-offs versus Japanese competition, especially in cars.

While GM and Ford can point to positive consumer and industry reaction to their upgraded vehicle portfolios, Chrysler’s new product push, based on Fiat platforms and technologies, is still over the horizon. And despite smart investments by GM and Ford in new automobile interiors and other feature and performance improvements, including a raft of technology enhancements, some entries are still playing catch-up to other global brands. Finally, GM and Chrysler need to rebuild their financing capabilities and dealer relationships, which were both badly damaged during the bankruptcy process.

For suppliers, the story is more mixed. Some acted daringly in the past year to restructure their businesses and are enjoying near record profitability and
cash flow, while less aggressive rivals are not yet earning their cost of capital. Moreover, too many suppliers fail to price innovation appropriately, allowing OEMs to quickly commoditize products that create real consumer value.

The Road Ahead

To navigate the course ahead successfully, automakers and suppliers must build on recent progress and diligently address the remaining fundamental issues that are most critical to their success.

Booz & Company believes that OEMs need to focus on eight areas:

- **Watch costs closely.** Sharp cost cuts over the past two years have positioned automakers to be profitable on much lower volumes, but more needs to be done. OEMs need to guard against excess cost creeping back in as volumes recover, and they need to work harder to achieve full competitiveness with industry leaders—for example, in labor cost and productivity.

- **Achieve superior quality, reliability, and durability (QRD).** American consumers are savvy enough to understand that QRD over long periods of time impacts total cost of ownership and ultimately affects residual value and consumer equity. Thus, gaining share in the U.S. market requires consistently exceeding well-established industry leaders in initial quality and convincing consumers that those gains will translate into improvement in long-term reliability and durability.

- **Build attractive vehicles and brands.** Sustained product excellence is an absolute requirement for long-term success. Toyota, Nissan, and Honda have a rich legacy to draw on but cannot stand on their laurels, especially in the face of increasingly competitive products from their rivals. For the Detroit Three, there are significant gains to be realized by reconnecting customers to iconic brands and, in the process, earning the sale by offering real improvements in overall and relative value. The winning combination is great-looking vehicles, innovative technology, good fuel economy, and high QRD.

- **Require every vehicle to “pay its share of the rent.”** Historically, many automakers have not demanded that each vehicle model earn its true cost of capital or have a clear strategic justification in the portfolio. To generate sustainable profits, companies must embrace the discipline needed to predetermined the return on investment for all products. Better transparency of investments per vehicle and more realistic
estimates of likely volume and pricing levels based on reliable, hard data and forecasts are needed to drive improved product decisions.

- **Better align supply with natural market demand.** Too many cars are still chasing too few consumers. Instead, production capacity must continue to be adjusted to more closely match realistic projections of market demand. Setting the right capacity level involves a complex optimization algorithm that pits expected demand and sales variability, manufacturing flexibility, and the cost of lost sales against the price of excess capacity. In our experience, automakers inevitably struggle and often fail to achieve the most profitable equilibrium.

- **Improve revenue management and maintain pricing discipline.** Pricing and incentives need to be managed carefully for maximum profitability. Automakers have too often chased unit sales and market share at the expense of life-cycle profitability, pushing out more volume than the market “wants” and thereby eroding residual values—although the Detroit Three, historically the worst offenders, have shown much more discipline recently. Making the right pricing and promotion decisions requires advanced modeling to understand price-volume trade-offs and to estimate residual value effects, as well as a willingness to prioritize medium- and long-term profitability over immediate market share.

- **In some cases, revive financial and distribution channels.** GM and Chrysler must rebuild their finance capabilities. The recent acquisition of AmeriCredit by GM, which gives the automaker access to a large-scale leasing program as well as subprime customers, is a good first step and illustrates the types of deals that make sense for the Detroit Three in the current environment. Equally important, GM and Chrysler must heal the wounds in their dealer networks caused by bankruptcy-driven closures. Priorities include rebuilding dealer loyalty, ensuring that dealers have profits to invest, and taking advantage of their greater ubiquity (especially in rural areas).

- **Prepare for an even more globally competitive landscape – and recommit to investing in growth markets.** Automakers competing in North America need to be ready for the emergence of new international competitors with inherently lower cost structures from countries with exploding markets, notably Korea, China, and India. Hyundai is already demonstrating what these emerging OEMs can do, and others will follow. Competing successfully against these rivals will require continuous improvement in products, technologies, costs, investment
economics, and business models—all tied to a sales strategy that seeks to play a key role in emerging markets. Indeed, now is the appropriate time to reinvest in global growth markets and build profitable positions where much of the future volume growth will take place.

For suppliers, the challenge is to capitalize on recent improvements and build businesses that will reliably earn more than their cost of capital over the next cycle. In our view, three steps are required:

- **Ruthlessly manage cost.** This means minimizing cost in all aspects of the business, except when additional investment is absolutely essential to generate revenue premiums. It starts with sourcing, by structuring the supply base and relationships to minimize transaction cost while enabling sub-suppliers to earn a “fair” margin; moves into operations with the design of a factory that minimizes labor and production costs and maximizes productivity; and ends with overhead, which should be held to the minimum necessary to deliver innovation and manage the enterprise. Remaining ahead of competitors will often require continued refinement of the manufacturing footprint and deft handling of labor relations.

- **Get paid for value.** Some products are commodities, and achieving a price premium is unrealistic. But when a product helps an OEM create real marketplace differentiation, suppliers must set prices that match the value created. This can be difficult in an environment in which OEMs are pushing to commoditize all components, even differentiated content. But failing to take this step means giving away expensive, value-creating innovation to the automakers and ransoming the future for short-term gain.

- **Avoid winner’s remorse.** Bidding before products are fully designed requires an advanced capability to project costs with minimal uncertainty, and the discipline to accept only business that offers a high probability of profitability. Tier One suppliers must avoid taking business likely to be unprofitable to protect market share; if there is a strong temptation to do so, there are likely deeper underlying problems in the business that must be addressed.

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We are optimistic that 2011 will bring continued improvement as industry sales return to historical replacement levels. We hope you find these observations useful as you develop your strategies and plans.
We would be delighted to share our views on how your company can continue to improve its performance. Please feel free to contact any of us with your comments, questions, or inquiries.

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