International Finance

DICF
Deutsches
Institut für
Corporate Finance

Automotive Management

Navigating the next decade of auto industry transformation

by
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Oldenbourg Verlag München

We would like to thank Daimler AG for supporting the pictures on page XVII as well as page 198.

Bibliografische Information der Deutschen Nationalbibliothek

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

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Lektorat: Dr. Jürgen Schechler
Herstellung: Anna Grosser
Coverentwurf: Kochan & Partner, München
Umschlagfoto: Jens Diehlmann
Gedruckt auf säure- und chlorfreiem Papier
Gesamtherstellung: Druckhaus „Thomas Müntzer“ GmbH, Bad Langensalza

ISBN 978-3-486-59780-6

Foreword

The ongoing global economic crisis has resulted in the need for urgent change across the automotive industry.

The primary foci of the automotive industry include: adjusting for overcapacity in production, low profitability in new vehicle sales, stagnation of demand in the developed markets, and capitalizing on opportunities in the emerging markets. Auto manufacturers must now make significant investments in developing leading-edge, eco-friendly models, while applying the latest technology; both in vehicles and across their operations, in order to remain competitive. In addition, they must develop new revenue streams through innovative finance models. These finance models should be available to car buyers, and will be customized to meet the needs of consumers through local sourcing. They are also continuing to consolidate manufacturing operations worldwide, while automakers from India and China are simultaneously pushing their way into an already crowded market.

Automotive manufacturers across all segments are facing the demands of new market dynamics. In order to operate successfully, they must meet the challenges of this complex market with a multi-dimensional approach.

The book *Automotive Management in 2020: Navigating the Next Decade of Automotive Industry Transformation* provides a thorough, readable analysis, supplemented with extensive data. The analysis outlines options for strategic transformation within the industry, and also possibilities for innovative financial service products. The authors chose a provocative view point that lends itself to thoughtful debate. In this sense, this book will be a valuable contribution to navigating the right path for the global industry.

Dr. Alexander Scheidt
IBM Global Automotive Industry Leader

Foreword by the Authors

The text of *Automotive Management in 2020: Navigating the Next Decade of Automotive Industry Transformation* relates to the needs of automotive manufacturers over the next decade by examining a series of targeted questions, the broadest being: What are the central concerns of the automotive industry in the years to come?

Further, we at the German Institute for Corporate Finance, together with IBM (recognized for its vast practical experience from consulting projects and extensive market analyses across the industry), have educed the following five questions for the industry:

- What does the market of the future look like for automotive manufacturers?
- What are the strategic levers for the future?
- What are alternative scenarios?
- What is the importance of Captive Finance Companies (CFCs) for the OEMs?
- What new business models will differentiate Captive Finance Companies in the future?

Currently, automobile manufacturers are faced with the challenge that they seldom recover their total capital costs. Greater profit margins are primarily achieved through aftermarket sales (parts and service) and financing. The hope of profits through growth in emerging markets has yet to be realized. Even the booming markets in the BRIC nations are not sufficient to counteract the lagging profits of automotive manufacturers, as they, too have been impacted by the strained global economy.

Automotive manufacturers will only achieve a solution to the profit dilemma by following a transformation strategy aligned to their business and marketing needs. Currently, the respective approaches of most automotive manufacturers are fundamentally similar, which offers them few possibilities for differentiation. As very few manufacturers can achieve sufficient cost control, it makes sense to focus on those areas where there are still possibilities for differentiation. The goal of this book is to analyze the strategic approaches for automakers in light of new market dynamics, and to show possible options for action.

Globalization-centric challenges, new technologies, and strategic refocusing, will accelerate a wave of consolidation for automotive manufacturers, especially among brands. In *Part 1*, strategic options for automotive manufacturers are outlined. The case of Volkswagen and Porsche, which examines horizontal integration and financing, is examined in *Part 2* of the book.* In *Part 3* we demonstrate why Captive Finance Companies should be an integral component of every manufacturer's strategy.

We have attempted to write this book in clear language for those interested in the economic and political aspects, of the industry. It is oriented toward financial managers, controllers, corporate strategists, financial services providers and consultants.

We wish to thank IBM for their exhaustive research efforts, and for the funding of this manuscript. Our thanks also extend to the publisher, Oldenbourg, and the employees thereof: especially Dr. Juergen Schechler, a specialist in economics and social sciences, for his consistently pleasant, proficient and constructive collaboration. Further, we thank the individual employees of the German Institute for Corporate Finance and IBM, especially Mr. Nikolaj de Lousanoff (Manager, IBM), who greatly influenced the structure of this book through his analytical approach. We also thank Mr. Eduard Ciorogariu, Mr. Oliver Elsoud, and Mr. Klaus Wassermann, who insured the completion of this book. Mr. Ciorogariu contributed the Porsche/Volkswagen Case Study, Mr. Elsoud led the analyses of Captive Finance Companies, and Mr. Wassermann developed reports on the fiscal strategies of the automotive manufacturers discussed herein. We also thank Ms. Susanne Tomassetti for her corrections, and Ms. Doris Sperber for her excellent illustrations; both played an important role in the development of this book.

Frankfurt am Main, February 2010
Jens Diehlmann and Joachim Häcker

* The case study "Porsche/Volkswagen" in particular, as well as all other remarks in this book are based on analyses conducted by the authors, to the best of their knowledge. They are based solely on literature research and on publicly available information. We have inspected the information to the best of our knowledge, but are not liable for it (apart from liability for gross negligence). We bear no responsibility for the completeness or accuracy of this data. These analyses and conclusions in this book should not be used as the basis for investments in the stocks of these companies. We bear no liability for any financial actions taken by the reader.

The illustrations given in the book can be downloaded from the website of the Deutsches Institut für Corporate Finance (German Institute for Corporate Finance) (www.dicf.de). We would love to receive your comments and suggestions at

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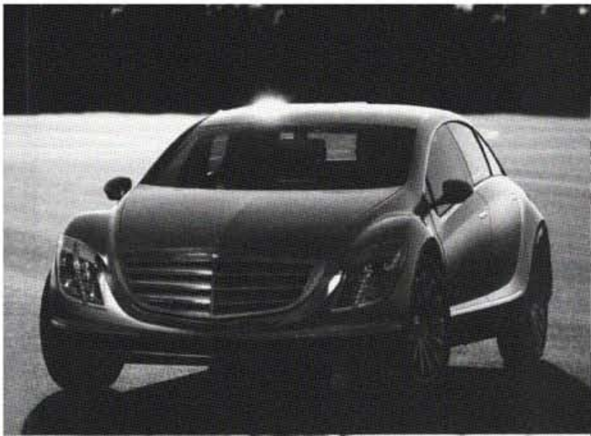
Contents

PART 1
Strategies: Automotive Manufacturers "Quo Vadis"?

List of Figures

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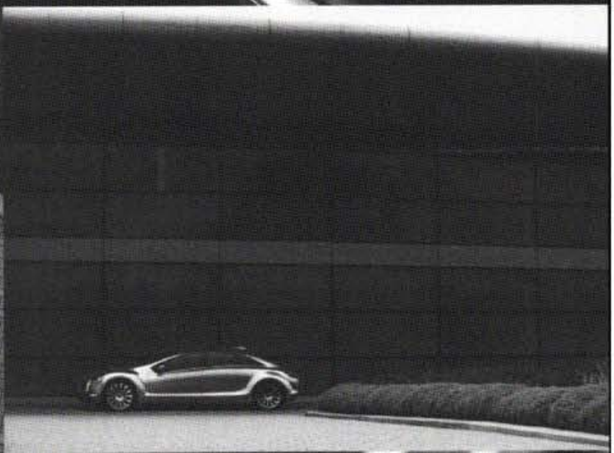


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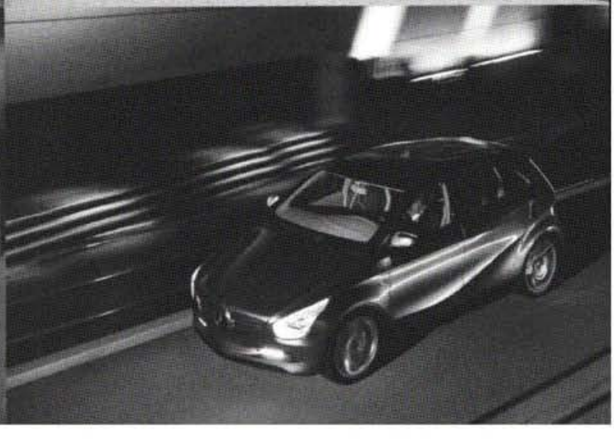

Executive Summary

The goal of this book is to analyse the future strategic approach of automotive manufacturers in view of rapidly changing market requirements. Here, the focus lies on presenting options for action from which a strategic positioning can be derived for the year 2020.

We have approached this goal in three steps.

PART 1
Strategies: Automotive Manufacturers "Quo Vadis"?

The investigation into the global automotive market shows the following four relevant options:

1. Geographical positioning to exploit opportunities in growth markets

2. Development of alternative energy propulsion to obtain technology leadership

3. Attaining greater horizontal integration to access new markets; diversify product offerings; and achieve greater scale; as well as vertical integration, to optimise the supply chain

4. Strategic use of Captive Finance Companies, to attain a stronger hold on the market through expansion of the value chain; and greater customer retention

Although each of these four options play a significant role in the ongoing evolution of the automotive industry, the larger focus of this analysis is on the topics related to horizontal integration and the strategic use of Captive Finance Companies (CFCs). These two specific focus areas are expected to lead to major changes for automotive enterprises in the coming years.

In analyzing automakers, we found that their respective fiscal and strategic approaches varied widely. In fact, of the 10 premium and volume manufacturers studied here, only 4 followed a clearly defined fiscal strategy.

The analysis shows that the automobile manufacturers we analyzed must strengthen their activities with respect to market requirements and core competency in their respective segments.

PART 2
Porsche and VW: A Case that Wrote History

The Porsche / VW case is an excellent current example of horizontal integration. Based on publicly available information we will document the chronology of this takeover battle, ongoing since 2005. This includes the finance and communications strategies. We especially focused on the issue of funding of the deal received through options, which has materially impacted the merger battle.

PART 3
Captive Finance Companies (CFCs): The Future Instrument of Manufacturers

The strategic importance of the Captive Finance Companies to enable the strategic transformation of automotive enterprises is examined in the last part of the book. We have included a detailed overview of the most important actors in the market, the business model, and a review of various financial products. CFCs serve the manufacturers as a refinancing and customer retention instrument.

The current economic crisis has resulted in new challenges, even to this previously profitable business model. Against this background, the financial service providers are forced to strategically redesign/reinvent their business model to continue to be of use to automobile manufacturers. Some attractive options include developing foreign agency banks, used car financing, and extending finance companies to the emerging markets.

PART 1

Strategies: Automotive Manufacturers Quo Vadis?

1 Introduction

1.1 Problem Statement

Today, there are nearly 1 billion cars on the road worldwide. Since 2007, when global automotive production stood at its peak of 72 million vehicles, the demand for new cars has steadily decreased. Due to the global economic crisis, a sales decrease of 15 to 20% was projected for the year 2009. But, due in large part to government sponsored initiatives (such as Scrap Premium in Germany and Cash for Clunkers in The US) sales of new cars only dropped by 3%, to 67 million units:[1] Above all the global automotive industry has remained a strong growth engine and a huge contributor to the well being of people and society, with millions of people living from the automobile.[2] The automotive industry is also a critical economic growth driver to the other industrialized countries discussed in this book.

In recent years the market for new cars has become increasingly strained. Through the consolidation of manufacturers, market saturation, price wars, and global overcapacity, sales and profits in the traditional business of automotive enterprises have significantly decreased. Figure 1 illustrates overcapacity across a subset of the manufacturers that we studied.

1 Refer to the German Association of the Automotive Industry [VDA] (2009)

2 Refer to the German Association of the Automotive Industry [VDA] (2009)

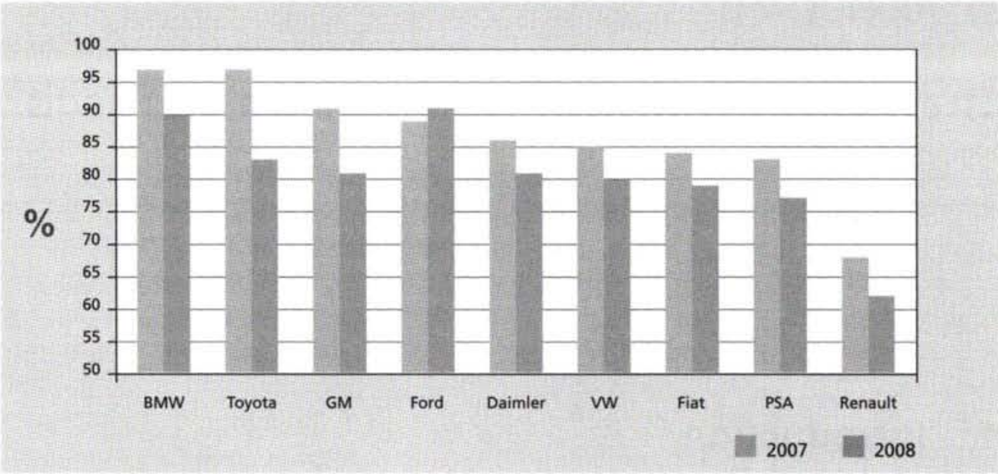

Figure 1: Utilisation of production capacities
Source: Credit Suisse Equity Research (2009)

In the coming years, the industry's emphasis will shift from the traditional emerging markets of the Triad (EU countries, North America and Japan) to the developed markets. Product focus is also moving from conventional to alternative propulsion technologies. These long-term trends that began at the end of the last decade have accelerated due to the worldwide recession and require an immediate and strategic response from automotive enterprises.

1.2 Procedure

In the following section, we examine these trends in greater detail. We first address the connections between the global automotive markets and their respective participants. Against the backdrop of globalization and a demanding economic environment, potential actions will be evaluated for the industry. We will also compare developmental scenarios in order to make recommendations for specific manufacturers and to assess their viability. Part one of this book will conclude with a vision of the industry in the year 2020.

1.3 Definition

Original Equipment Manufacturer (OEM)
An Original Equipment Manufacturer is a manufacturer that incorporates components delivered by outside suppliers into its own product, then markets and sells the delivered component under its (the OEM's) company name. The term 'original equipment manufacturer' and the term 'automotive manufacturer' are used synonymously in this analysis.[3]

2 Overview of the Global Automotive Markets and Manufacturers

This chapter will examine the automotive markets of Europe, North America, and Asia. The majority of manufacturers are in these markets and will serve the current and future global automotive industry.

2.1 The Global Automotive Market in Overview

The global vehicle market includes two segments: automotive manufacturers (cars, commercial and utility vehicles), and motorcycles. In 2008, motorcycles amounted to only 4.8% share of the total vehicle market. Given such an insignificant portion, we did not consider this segment in our analysis.[4] The current economic crisis has significantly impacted the automotive industry. The global turnover of the automobiles and components industry amounted to 2.4 billion US dollars in 2008: a 14.5% deficit from the previous year.[5]

The BRIC markets, with the exception of Russia, continue to experience enormous growth, while the traditionally profitable markets of Western Europe, Japan, and North America are undergoing decreased sales. Figure 2 shows that negative growth rates (CAGR) are predicted through 2012 for the saturated markets of the U.S., Japan and Western Europe. Significant growth potential exists only in the growing and developing markets of China and India.

3 Refer to Gabler (2009)

4 Refer to Datamonitor (2009a), S. 11

5 Refer to Datamonitor (2009b), S. 9

Car sales YoY %	2008	2009	2010E	2011E	2012E	CAGR
China	7.3	7.6	2.2	6.4	10.0	6.7
India	1.8	6.3	7.6	5.5	9.5	6.1
Brazil	13.9	-2.2	-1.9	3.8	1.9	2.9
Russia	15.4	-33.3	5.0	16.7	16.3	1.9
Japan	-5.7	-15.2	0.0	4.8	0.9	-3.3
USA	-16.3	-19.7	17.9	10.4	5.1	-2.1
West Europe	-8.5	-6.2	-3.5	7.6	3.9	-1.5
Total	**1.1**	**-9.0**	**3.9**	**7.9**	**6.8**	**1.5**

Figure 2: Development of car sales in specific markets (in %)
Source: Credit Suisse Equity Research (2009)

A growing population and low per capita vehicle ownership in India and China have combined for an explosion of growth in their respective markets. Vehicle density (see figure 3) refers to the number of vehicles driven per 1,000 inhabitants. In the U.S., there are approximately 800 more cars per 1,000 inhabitants than in India or China. Europe and Japan also have a markedly higher vehicle density. Future sales in these established markets will consist mainly of replacement vehicles rather than new growth.

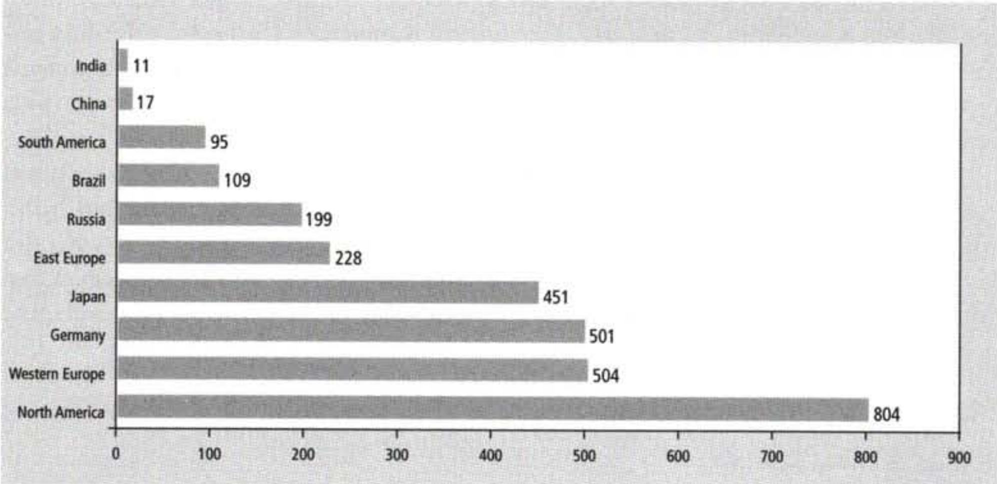

Figure 3: Car density (by unit) as per world region
Source: IWK – Institut for Wirtschaftsanalyse and Kommunikation (Institute for economic analysis and communication) (2009)