GM and Chrysler

Follow the money

Merging the two sickly car firms makes little sense—except for one thing

OBJECTIONABLE, but necessary. The description by Hank Paulson, America's treasury secretary, of the federal rescue package for America's banks, is a mantra that may soon be repeated in boardrooms across the land as recession-hit firms survey their dwindling options for survival. Few areas of the economy have been battered harder or for longer than the car industry, especially Detroit's Big Three. So the news which surfaced at the end of last week that General Motors (GM) and Cerberus Capital Management, the private-equity outfit that was paid $7Oom by Daimler to take Chrysler off its hands just 17 months ago, had been talking about a possible merger between the biggest and the smallest of the Big Three was a surprise, but hardly shocking.

GM and Chrysler have been on the critical list for months, as has Ford, which also recently had some short-lived preliminary discussions about a tie-up initiated by GM, its bigger (but sicklier) rival. All three firms were in the midst of far-reaching cost-cutting and restructuring plans when they were hit by surging oil prices and tightening credit. This hurt the carmakers in three ways. First came a catastrophic drop in demand for the gas-guzzling pickups and sport-utility vehicles that have accounted for most of Detroit's profits in recent years. Then came a collapse in earnings from leasing, as the residual values of fuel-thirsty vehicles plummeted. This was followed by the drying up of credit to fund new-car purchases. The carmakers' finance arms, usually good earners in bad times, have more or less shut up shop.

That Cerberus should be desperately seeking an exit from its ill-judged foray into the car business is understandable. The deal it has proposed to GM is said to involve swapping Chrysler for the 49% of GMAC (GM'S lending arm) that Cerberus does not already own. Cerberus no doubt calculates that GMAC will be eligible for some of the government's bank-bail-out money and that its fortunes will eventually improve—whereas it probably sees no future of any kind for an independent Chrysler. It is rather harder to see what the attraction of absorbing Chrysler might be for GM ("merger" is a cruel euphemism).

GM already has too much of all the things Chrysler has to offer. It certainly does not need more brands, for example. With nearly a dozen of its own, GM already has too many for its shrinking market share. Although Cerberus might claim that Jeep still has resonance, the Chrysler and Dodge brands are damaged goods, worthless outside America. Nor does GM need more truck factories, when it is cutting its own capacity as fast as it can.

To make matters worse, notes Jim Hall, an industry consultant who used to work for GM, most of Chrysler's 3,500-strong dealer network would, under American law, have to be bought out at a total cost of well over $1 billion. And Chrysler does not have any compelling new models in the pipeline that might make it seem a more attractive proposition in the future. Having just launched (with almost hilariously bad timing) the new Dodge Ram pickup, Chrysler will have nothing fresh to sell until the small, Nissan-made Dodge Hornet arrives in 2010.

Meanwhile, Chrysler has announced that it is working on three electric vehicles, two of which will use similar range-extending technology to GM'S keenly awaited plug-in hybrid, the Chevrolet Volt. But GM is a lot further down that particular road and Chrysler admits it only has the resources to apply the new powertrain to existing models. Cynics suggest that the main purpose of Chrysler's electric-vehicle programme is to allow it to snag its share of the $25 billion loan package agreed on by Congress last month to speed up the development of fuel-efficient cars.

A further consideration for GM is whether it really has the stomach for the opprobrium that is sure to come its way. Closing down much of Chrysler would enrage government, the unions, the dealers and the automotive-parts suppliers, all of whom GM depends upon. David Cole of the Center for Automotive Research, an industry body, thinks it might just be worth it if the terms of the deal were right. "The trick is making it through the current period," he says. "But you have already taken out a lot of capacity and that is going to help restore pricing power in the industry for the first time in more than 10 years." Maybe, but GM'S rivals would enjoy the same benefit while enjoying a free ride.

The real prize for GM might, however, be something much more tangible. In August Cerberus claimed that Chrysler still had $11 billion in cash from loans raised earlier. There is speculation that it might be willing to throw that in, and add some more, in exchange for a stake in the merged entity. GM, which is currently burning through more than $1billion a month, had access to $21billion in cash and $5 billion in credit at the end of June. Brian Johnson, an analyst at Barclays Capital, thinks that the carmaker needs a further $10.3 billion to get it through to the end of next year, when cost savings and recovering demand should start to kick in. As one of GM'S rivals observed this week: "We think it's cash that's driving this pony." •

Follow the money. **The Economist**, New York, v. 389, n. 8602, p. 72, 18 October. 2008.