A giant falls

The collapse of General Motors into bankruptcy is only the latest chapter in a long story of mismanagement and decline.

Alamy

Since the start of the year it had seemed probable, and for several weeks inevitable. General Motors' application on June 1st for Chapter 11 protection from its creditors, triggering the biggest industrial bankruptcy in history, was nonetheless a momentous event.

The filings lodged at 8am with a court in Manhattan were testimony to the size and complexity of the 101-year-old company and to the scale of the problems that had finally overwhelmed it. Until 2008, when it was overtaken by Toyota, GM was the world's biggest carmaker, producing well over 9m cars and trucks a year in 34 different countries. It has 463 subsidiaries and employs 234,500 people, 91,000 of them in America, where it also provides health-care and pension benefits for 493,000 retired workers. In America alone, it spends $50 billion a year buying parts and services from a network of 11,500 vendors and pays $476m in salaries each month.

Amid the huge numbers, one comparison stood out: against assets of $82.2 billion, GM has liabilities of $172 billion. A year ago, realising that GM was running out of cash, Fritz Henderson, then the chief financial officer, sought to raise $3 billion through a sale of bonds or shares. When it became clear after the collapse of Lehman Brothers in September that there was no chance of success, he attempted to sell some non-core assets. That too failed. Mr Henderson, who became chief executive when Rick Wagoner was ousted in March, says in an affidavit that no one expressed any interest in lending to GM or buying its assets at a price that would have kept it operating. (This week GM managed to find a Chinese buyer for its Hummer SUV brand, but the price is thought to be far below GM's $500m valuation.) In November GM's share price fell to $3. The only route still open led to the federal government.

An autumn's warmth does not endure

Yet as recently as the autumn of 2007 Mr Wagoner's stock had been high. There was hope both inside GM and among industry commentators that after three years of huge losses and painful downsizing the carmaker was at last on the road to viability. The chief cause of optimism was a deal with the United Auto Workers (UAW) union to transfer health-care liabilities to a union-run trust fund and to reduce the pay and benefits of newly hired workers to rates similar to those at the "transplant" factories of rivals such as Toyota and Honda. That October the price of GM shares rose to nearly $43, the highest for more than three years.

Better still, independent surveys were reporting that many of GM's factories had closed the efficiency gap with Toyota. And guided by Bob Lutz, a quintessential "car guy" whom Mr Wagoner had appointed in 2001 to oversee product development, GM was also making some

pretty good cars, among them the fast-selling Buick Enclave and the award-winning Chevrolet Malibu and Cadillac CTS. The Chevrolet Volt, a revolutionary electric car with a “range-extending” internal-combustion engine, due to be launched in 2010, made Toyota’s Prius hybrid look a bit dated. In late 2007, after years of decline in North America and despite cuts in dealer incentives and sales to car-rental firms, GM’s market share was edging up.

The final element of this cheery prognosis was GM’s success outside North America, especially in fast-growing emerging markets. For all his sometimes plodding approach at home, Mr Wagoner had proved surprisingly fleet of foot abroad, where GM was making 65% of its sales (see chart 1). GM had long been big in Latin America, but in China and Russia it was reaping the rewards from being among the first foreign firms to set up factories. In China, with its joint-venture partner, SAIC, GM now has 12% of a market that will soon surpass America’s.

But, as at other times in GM’s recent troubled history, the promise of that autumn turned out to be false. By the end of 2007, the weakness of the American housing market was infecting sales of cars. Falling house prices caused many people to put off getting a new car, while willing buyers with below-average credit ratings were finding it increasingly hard to finance prospective purchases, new or used.

On top of that, petrol prices nearly doubled. With a gallon costing $4, demand for the big pickups and SUVs that provided most of Detroit’s profits evaporated. In the scramble to swap gas-guzzlers for smaller vehicles, residual values collapsed, leaving GM’s finance arm with huge losses on cars returned after lease. After Lehman failed, car markets were clobbered around the world, but America’s was hardest hit. Sales of cars and light trucks in December 2008 were 35.5% lower than the year before. After four years of restructuring efforts during which it had lost more than $80 billion, GM was too enfeebled to stagger on.

Where did it all go wrong?

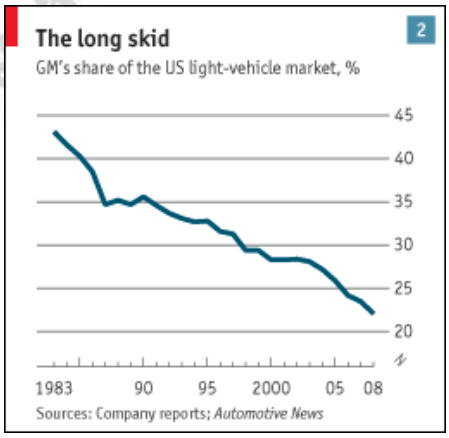
In some ways, GM’s problems can be traced to its origins a century ago. Between 1908 and 1920, its founder, Billy Durant, bought 39 companies including Cadillac, Pontiac, Oldsmobile, Chevrolet and several parts-makers, but ran them as separate entities. In 1923, after narrowly avoiding bankruptcy, Alfred Sloan, a ball-bearing magnate, took over the running of GM. Sloan imposed tight financial controls and brought order to the chaotic model line-up. Yet even as GM expanded abroad, establishing factories in 15 countries and buying Vauxhall in Britain and Opel in Germany, Sloan made little attempt to forge a unified company at home. The different divisions were run almost as independent fiefs that fought among themselves and against any interference from the centre.

Still, GM was doing well enough after the second world war to accede to the deals with the UAW that, much later, were to become an insupportable burden. It agreed in 1948 to annual cost-of-living pay increases and in 1950 to free health-care coverage for life and generous pensions. With hardly any foreign competition in America and its main Detroit rivals, Chrysler and Ford, forced to offer their workers similarly gold-plated benefits, GM's sheer scale masked any inefficiencies. By the early 1960s, with its market share at over 50%, its bosses were more worried about avoiding antitrust action and a possible break-up than reducing costs or improving GM's cumbersome, committee-bound way of making decisions.

Only in the 1970s, after the first oil shock, did faults start to become visible. The finned and chromed V8-powered monsters beloved of Americans were replaced by dumpy, front-wheel-drive boxes designed to meet new rules (known as CAFE standards) limiting the average fuel economy of carmakers' fleets and to compete with Japanese imports. As well as being dull to look at, the new cars were less reliable than equivalent Japanese models.

By the early 1980s it had begun to dawn on GM that the Japanese could not only make better cars but also do so far more efficiently. A joint venture with Toyota to manufacture cars in California was an eye-opener. It convinced GM's management that "lean" manufacturing was of the highest importance. Unfortunately, that meant still less attention being paid to the quality of the cars GM was turning out. Most were indistinguishable, badge-engineered nonentities. As the appeal of its products sank, so did the prices GM could ask. New ways had to be found to cut costs further, making the cars still less attractive to buyers.

Respite came with the decline in oil prices from the late 1980s and an anomaly of the CAFE regulations that allowed passenger vehicles classed as light trucks a much slacker standard. Rather than invest in low-margin cars, GM and the two other Detroit firms concentrated on building profitable pickups and SUVs. After recovering from losses of over $30 billion in the early 1990s, the company was in trouble again at the beginning of the next decade. Its market share had been steadily falling (see chart 2), while higher interest rates and an economic downturn led to a pensions and benefits crisis. However, thanks to Mr Wagoner's first efforts at restructuring, by 2003 GM's market share in America had stabilised at 28% and it was making profits of nearly $4 billion.



It could not last. Every year the cost of retired workers' health care diverted billions of dollars from developing new models and added $1,400 to the cost of each car compared with those made in Asian and European transplants. Mr Wagoner had little choice but to generate cash to feed the beast. That meant keeping production high and sustaining sales with costly dealer incentives, cheap credit and heavily discounted fleet sales. That in turn hammered residual values and damaged GM's brands. It is easy to say with hindsight that Mr Wagoner should have done more to prevent the slide. But had a more confrontational manager forced an earlier showdown with the union, downsized faster or tried to hack back a sprawling dealer

network protected by state franchise laws, he might merely have hastened bankruptcy. It may be fairer to say that, dealt a rotten hand, Mr Wagoner tried to do many of the right things, but ran out of luck and time.

The car-industry task-force appointed by Barack Obama to save GM and Chrysler quickly concluded that neither could be viable without the pressure of bankruptcy to force stakeholders to renounce most of their claims. But it also recognised that a long period in Chapter 11 could be fatal. Not many people want to buy something as expensive and durable as a car from a company that may not be around next year. The task-force is therefore forcing through “quick rinse” or “pre-packaged” bankruptcies to separate the good assets from bad assets and liabilities speedily. The idea is to allow a new, cleansed company to emerge in a matter of weeks (as with Chrysler) or at most a few months (GM).

New beginnings?

At Chrysler, everything seems to be going according to plan. Fiat, which will take over the running of the business, will have 20% of the new company, rising to 35% on reaching certain goals. A union trust will have 55% and the government 10%. This week the judge handling the bankruptcy, Arthur Gonzalez, cleared the way for a spruced-up Chrysler to exit the court soon after the good assets are transferred to Fiat. An appeal by some Chrysler creditors may delay this by a few days.

Although GM’s bankruptcy will be more complicated and drawn out, a new entity should emerge before September. The government, which is putting $30 billion into GM on top of the $20 billion it has already handed over, will receive 60.8% of the stock. The Canadian government, which is providing $9.5 billion, will get 11.7%. The UAW’s trust will have 17.5% and the bondholders 10%. Despite the size of its stake, the government is adamant that it is a reluctant shareholder and will stay out of managing the business. It hopes that within 18 months GM might become a publicly traded company again.

Happy days - Alamy

The new GM will shed about 14 factories, 2,400 dealers, 21,000 hourly-paid jobs, 8,000 white-collar jobs and, crucially, $79 billion in debt. The aim is for the company in North America to be able to break even in a domestic market with annual sales of 10m vehicles. Today’s extremely depressed market is running at about 9.5m. A recovery is forecast to start next year, but it may take time for sales to return to the 15m-17m seen between 1995 and 2007.

No one believes that GM will return to its former glory. The question is whether the new, smaller GM can succeed on its own more modest terms. Without doubt, its structural costs will be much lower: $23.2 billion in 2010, against $30.8 billion in 2008. With fewer brands and dealers it will be able to focus marketing and advertising more effectively. GM also retains the design and engineering resources to develop competitive cars, although the good ones are still outnumbered by the dross. The new-model pipeline has enough in it to keep buyers interested. Its successful operations in China should continue to grow rapidly with the market there.

But several doubts remain. The first is that although Mr Wagoner has gone, there has been no cull of GM's leaders—who helped to get it into this mess. Mr Henderson is an experienced financial manager, but GM may need someone more inspiring to shake it out of its consensual, bureaucratic ways. Senior members of the auto task-force found Chrysler to be better run in some ways than GM.

Second, although GM's cost base will be more in line with that of its transplant rivals, it will still be handing about $600m a year to the UAW in the form of dividends on preferred stock to comply with the revised health-care agreement. On the rather rosy assumption that GM sells 2m vehicles a year in America, each one will have to carry $300 in health-care costs. Unresolved questions remain about the firm's pension fund, which at the end of 2008 was underfunded by about $13 billion.

Third, GM's market-share forecasts still look optimistic. It expects its share to stabilise at around 18.5%, only one percentage point below its figure for this year. But GM will have fewer brands and dealers, and rivals will be eager to exploit its withdrawal from parts of the market. Volkswagen, for example, is planning an assault. It is building a new factory in America with the capacity to turn out 250,000 cars a year and is aiming to triple its market share from 2% to 6% by 2018, with sales of 800,000.

Fourth, there is a danger that with the government as its biggest shareholder, GM will be pushed into making the kind of cars—smaller and more fuel-efficient—that Mr Obama approves of rather than the sort Americans want to buy. Although new CAFE standards should encourage the shift away from the thirstiest models, trucks still get off too lightly and the administration seems to have no appetite for the one thing that would radically change buying habits: a big increase in petrol taxes or a more widely applied tax on carbon.

Finally, as Max Warburton, an analyst with Bernstein Research, notes, GM has suffered as much from a price problem as from a cost problem. GM's vehicles sell for between $3,000 and $10,000 less than Toyotas of the same size. "This is a brand issue", says Mr Warburton, "and the brands won't be fixed by Chapter 11." Most younger buyers have simply never considered a GM car. The new Malibu medium-sized saloon is just as good as the Toyota Camry, Honda Accord and Nissan Altima, yet is still shunned by many drivers because it is a Chevy. If anything, bankruptcy and subsidies from the taxpayer will tarnish GM's brands even more. The few Americans who buy cars for patriotic reasons are more likely to head for a Ford showroom to reward the company for its dogged fight to avoid the fate of its Detroit rivals.

When GM emerges from bankruptcy, it will have shed some of its burdens, but the damage done by decades of mismanagement and union intransigence will still weigh heavily. The new GM will not be quite as new as either it or the government would like Americans to believe.

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