Working together for a healthier world™
Rollover to expand

Comment (47)
Recommend (86)
E-mail
Share
Print
Reprints & permissions

The car industry

Small isn't beautiful

Sep 17th 2009 | FRANKFURT
From *The Economist* print edition

Carmakers have escaped calamity. Now they face a big, long-term problem: people are moving to smaller vehicles

AFP

BIG motor shows are good barometers of the car industry's mood. Twelve months ago in Paris, in the wake of the collapse of Lehman Brothers, the mood was dread—the knowledge that something terrible was about to happen. At the beginning of this year, at the show in devastated Detroit, and a few months later in Geneva as Chrysler and General Motors prepared for bankruptcy, it was all about the struggle to survive. This week in Frankfurt the industry gave a sigh of relief, confident that the worst was over but painfully aware there would be no return to business as usual any time soon, if ever.

The sense of relief is understandable. After the collapse in sales and savage production cutbacks that took place in nearly every big market nine months ago—with the huge exception of China—volumes have started to rise as inventories are cautiously rebuilt. Balance-sheets appear to have been stabilised if not repaired. There is even a good chance that in the final quarter of this year some of the big carmakers will return to (very modest) profit, while others will do so next year. Credit, the lifeblood of the industry, is flowing again,

Related Items
From *The Economist*
The car industry's troubles
Sep 17th 2009
More articles about...
The motor industry

Advertisement
SAVE $348
The Fairy Tales Collection
Plus this FREE gift
Oxford Dictionary & Thesaurus
only $14.95

All research tools
Articles by subject
Economics A-Z
Special reports
Style guide

Country briefings
All country briefings
China
India
Brazil
United States
Russia

My account home

Newsletters and alerts
Manage my newsletters
Manage my e-mail alerts
Manage my RSS feeds
Manage special-offer alerts
More »

Print subscriptions
Subscribe to *The Economist*
Renew my subscription
Change my print subscription delivery, billing or e-mail address
Pay my bill
Activate premium online access
Report a missing copy
Suspend my subscription
More »

Digital subscriptions
Subscribe to Economist.com
Manage my subscription
Mobile edition
Audio edition
Download screensaver
More »

Classifieds and jobs

The Economist Group
About the Economist Group
Economist Intelligence Unit
Economist Conferences
Intelligent Life
CFO
Roll Call
European Voice
EuroFinance
Reprints and permissions

EIU online store

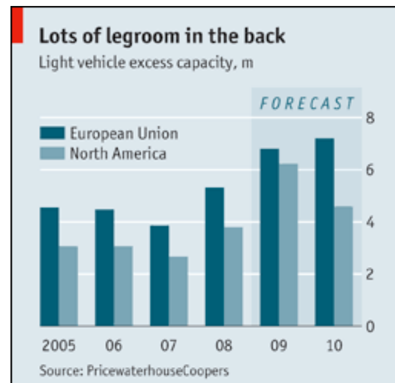
Economist shop

Advertisement

THE FOLIO SOCIETY

albeit somewhat anaemically. Particularly in Europe, government-sponsored scrappage schemes have brought buyers back into the market. And manufacturers are now enjoying reduced costs, partly from lower raw-material prices and partly because they have laid off workers.

What has not happened is any substantial reduction in capacity, particularly in Europe where factories are capable of churning out 4m more cars than the market can take even in a good year like 2007 (see chart). Not long ago it was widely assumed that the downturn would be sharp enough to take out more than one big carmaker. For better or worse, governments have done their utmost to stop that happening. Like the bailed-out banks, GM was probably always too big to be allowed to fail. But few expected sickly Chrysler to survive in anything like its present form. The removal of Opel/Vauxhall, one of the weakest big producers in Europe, would have done the industry a power of good.



Yet, thanks to President Obama's auto task-force and a shotgun marriage with Fiat, Chrysler motors wearily on. German government largesse paved the way for Magna, an auto-parts firm, and Russia's Sberbank to buy a majority stake in Opel/Vauxhall from GM on the condition that no plants will be closed in Germany. GM even found buyers for tiny Saab in Koenigsegg, a boutique Swedish sports-car firm, and China's Beijing Automotive. Volvo, which is bigger and healthier than its Swedish rival, may be sold to Geely, China's biggest privately owned carmaker. Far from consolidating, the European industry has instead gone in the opposite direction.

Although cuts at GM and Chrysler have removed some (though not enough) excess capacity in America, not a single car factory in Europe has closed so far. That is one reason why the carmakers assembled in Frankfurt believe that the normal strong, cyclical rebound may not happen this time. There are plenty of others.

One worry is the effect of withdrawing scrappage incentives. These have propped up demand this year, especially in Germany where they drove volumes to record levels. Optimists say that at least 70% of the scrappage purchases were incremental sales made to people who would not normally have bought a new car. But car-company bosses fear that volumes in Europe could slide next year unless "normal" new car buyers—well-off people and companies—return to the market. Even if scrappage schemes are continued or tapered, there may not be many buyers left who meet the qualifications.

Although the scrappage schemes have kept factories going, most of the action has been geared towards cheap, small vehicles which are less profitable for carmakers. They have thus weakened the "mix"—the balance of small and large vehicles sold—and reduced margins. The balance may swing back slightly next year, but the mix is threatened on a number of fronts in the longer term, raising doubts as to whether margins will return to their previous levels over the next few years.

To understand the importance of the mix, says Max Warburton of Bernstein Research, compare the cost of producing a small car such as the popular Fiat 500 with that of making a hulking sport-utility vehicle such as the Audi Q7. Mr Warburton calculates that the fixed costs are nearly identical, whereas the variable costs of making the Q7 (labour, raw materials and so on) are only about €10,000 ($14,700) higher for the Audi. Yet the Fiat sells for as little as €10,000, compared with a sticker price of at least €40,000 for the Audi. So a permanent shift toward smaller cars would devastate industry profits.

One big reason to expect such a shift is that the very cheap lease finance that manufacturers have relied on to stoke demand for their more costly cars, especially in America, Germany and Britain, is probably a thing of the past. Credit is unlikely to be so easily available again. Also, one of the ways leasing made more expensive cars seem affordable was by attributing to them high second-hand values after the lease was over. But higher volumes have dimmed the aura of exclusivity on which high residual values depend. BMW in particular has been badly hit by losses on returned cars and has cut the number of lease contracts it writes by a third.

A second threat to the mix, especially for the German premium makers, is

demographic change. Arndt Ellinghorst of Credit Suisse says that by 2020 40% of new car buyers in developed markets will be over 60, compared with less than 30% today. Although the affluent old like premium brands, particularly Mercedes, they tend to want smaller, cheaper cars. Being mostly retired, they are generally buying a car with their own, rather than with a company's, money. Empty-nesters do not need much carrying capacity. Over-65s also drive 45% fewer miles than the average, which means their cars last longer. Together with the growing durability of modern cars, Mr Ellinghorst reckons that underlying sales in developed markets could fall by as much as 30%. For growth in the sales of big, powerful prestige cars, manufacturers will have to rely on emerging markets.

A third threat to the mix is the ratcheting up of emissions legislation in almost every important car market as governments struggle to meet ambitious carbon-reduction targets. That seems certain to reverse the trend in recent years toward ever heavier and more bloated vehicles. It is also forcing manufacturers to invest abnormal amounts to develop clean technologies in the hope that their bigger vehicles can be made socially acceptable and escape penal taxation.

The executives gathered in Frankfurt this week were aware that threats to the mix, and therefore profits, are long-term and structural rather than short-term and cyclical. They also acknowledge that the industry will have to wean itself from the habit of using profits from bigger cars to subsidise smaller ones, and find a way to start building downsized vehicles that make money. Nick Reilly, who heads GM's international operations, says that part of the answer is to adopt low-cost manufacturing techniques and not to load cheap cars with unnecessary technology. By contrast, Lewis Booth, Ford's chief financial officer, reckons that the solution is to make small cars that are as good to drive as bigger ones and charge accordingly. Half of the Fiestas sold by Ford in Europe come with the top-of-the-range Titanium specification and are decently profitable, he says.

The problem confronts everyone (with the possible exception of Fiat, which has problems of its own), but it is most acute for the German premium makers, which dominated the Frankfurt show with their huge displays. Mercedes and BMW have enjoyed the best margins in the business, but they have lost lots of money on their small cars. BMW struggled to make a profit until recently even on its very successful Mini. Their rival Audi, being part of the massive Volkswagen Group, already has access to the technology and platforms it needs to make profitable small cars. To compete, Mercedes and BMW may have to do the unthinkable and join forces—either that, or risk their brands by forming partnerships with high-volume producers.

At the same time, the industry must tackle the problem of overcapacity in mature markets. Paradoxically, that may be easier once economies have emerged from recession and unemployment is no longer quite so high on the political agenda. More than anything, overcapacity undermines pricing power. The industry may feel it has come through a near-death experience in better shape than it could have hoped at the beginning of the year. But a return to health will take a lot longer.

Back to top ^^

Readers' comments

Readers have commented on this article (the window for new comments is now closed).

View all comments (47)

Want more? Subscribe to *The Economist* and get the week's most relevant news and analysis.

Advertisement