

The U.S. Auto Industry: A New Day

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Good morning. I am honored to speak before the Detroit Chinese Business Association today on some of my thoughts regarding the U.S. Auto Industry.

Sometimes we see the turning points in our lives as we live them. Other times, only the future provides the necessary vantage point from which to appreciate how a unique period of history profoundly alters a life, or an industry, or even a nation. I believe that we are living in one of these pivotal moments of change in the American auto industry today. A new day.

The car biz. My own business for almost 30 years. One of the giants, nay one of the goliaths of industries. And now, we are in the middle of a wrenching transformation. Boom times for some, bust for others. For like steel and airlines before it, traditional U.S. auto will profoundly restructure....in court and out of court over the next few years....or disappear to be absorbed into successful global players. There is simply no future in the status quo. Truly new day.

How could this have happened? How could this tsunami sweep through the domestic car business when just a few short years ago, we were gloryin' in the good times, top of our game, enjoying peak industry volume and profits and positive shareholder value. Rollin' in dough, drivin' those gas guzzlin' SUV's and feelin' fine. Ah! I do love the car business—especially in the good times.

Of course, for those of us who have been around for a while, we know that the good times seldom last. And so, in the last few years, came dramatic OEM market share shifts accelerated by a flood of global brand choices and the consumer switch to more fuel efficient vehicles. Strengthening international

automakers. Skyrocketing commodities prices. Successive supplier bankruptcies. The aggressive entrance of private equity as the swaggering new owners. The beginning of the apocalypse or the enlightenment depending upon your perspective. Some of the following trends have been ramping for some time but this is truly the emotional convergence for the car business. For now, even those who might have believed this to be just another down cycle in the historically cyclical car business now realize that this roller coaster ride is different --- this one is structural --- these changes are here to stay.

At first blush, one wonders why you wouldn't want to steer clear of this dinosaurian industry. Why are so many attracted? Why are you all here today? Because, actually -- overall -- the car business is strong, vibrant and growing. In the global market, we have had record or near record annual sales -- from 59.9 million vehicles in 2003 to 68.7 million in 2006, up nine million units in just these few years. That's the equivalent of 35 new assembly plants, 16 engine plants, 16 transmission plants, over 20 stamping plants, dozens and dozens of component operations and almost a quarter a million new jobs worldwide. Sure, the forecast might be flat for 2007 but this is only one year. Plus, the product itself is seductive, providing personal mobility ... a freedom so many crave. The styling and brands define cultures, and are embodied in music, in media, in the memories of generations. Sure, maybe it's a tough business but aren't they all?

So, what caused the change ... the trauma of the old domestic auto industry? What lessons can we learn for the future? The biggest change -- globalization. I don't mean the 80's version of globalization. I mean the "Thomas Friedman-world-is-flat, virtual, high speed with accelerating velocity, and Shanghai-Tokyo-New York-London and Ouagadougou are our next door neighbors" kind of globalization. Not just the developed markets investing in

emerging markets ... that been going on for decades, even centuries. I mean the successful “foreign” investment in developed markets. Like the Japanese and Korean automakers expanding production here and Europe. Like all of you here to build your U.S. businesses for the future. And I mean a world where the consumer has complete information at their fingertips, not just for their own market but for any market in the world. This is why disparities in vehicle pricing across European countries or between Mexico, Canada and the U.S. are disappearing, not just the trade pacts. Ahh. The challenges --- and rewards --- of this brave new world.

I, personally, am a strong supporter of globalization. Always good to be supportive of something you can't do anything about anyway. I've traveled to over 180 countries in my life and I strongly believe that the benefits of open trade and developed markets are crucial ingredients along with freedom of expression and the rule of law in a prosperous, democratic world. Open, competitive global markets foster the most rapid innovation and offer the widest array of products and services to the world's citizens. But while it's the right thing to do on a macro level, it's tough for many companies and individuals who planned their futures in a different time. There are tremendous opportunities but, on an individual level, the human opportunity is in a different place than the human toll.

Some think that the concentrated Chapter 11 restructuring wave in the car business is done. By the end of this year or maybe by the end of the first quarter next year depending on the financial markets, the big auto suppliers like Delphi, Federal Mogul, Dana, Dura and ASC should follow Tower Automotive out of bankruptcy. Any more big Tier Ones teetering? Or even an automaker like whispered a year ago? Nope, not right now. Sure, we'll see more Tier 2 and 3 filings as part of consolidation but we also see more out-of-court settlements and

pre-packaged deals as the recent bankruptcies have resulted in lower than expected recoveries for unsecured creditors, especially certain bondholders who had played the “loan-to-own” strategy only to find the fulcrum security determined to be lower than they had calculated, wiping out their positions and leveling the bidding field for new private equity entrants late in the game.

You’d think we’d learned nothing else during this last auto crash. High financial leverage in a business with high operating leverage and low margins ... bad idea! Remember this ... for next time we go through this roller coaster ride, because one thing for sure. We will go through this again in another decade or so. A new generation of brilliant young financial wizards with no memory of the last debacle will lever up companies using financial models that undervalue the likelihood of insolvency...models which prove with incontrovertible data that leveraging a company to the max will generate greater returns since the return on debt is cheaper than the return on equity especially when the risk of insolvency is factored at near zero. Look at the subprime mess if you doubt that brilliant financial people can underestimate risk.

Optimists would say that we have been through the worst. The GM/UAW labor deal represents a tremendous breakthrough. Automakers will benefit from lightened balance sheets, the likely improved credit ratings especially crucial for their financial arms and labor costs much more in line with international automakers producing in the U.S. The UAW will better control the retiree health care destiny of their constituency and will be a formidable force both in the national health care dialogue and as an investor of the VEBA funds. The two tier wage system will drive the domestic automakers to competitive wage levels over the next five years. And the policy and work rule agreements will yield another crucial round of productivity improvements. Together with the domestic

automakers, if the overall strategies are successful, the UAW may gain the job security that can really only come from working at competitive, profitable companies. GM and Ford have enough cash to last at least a few years despite the heavy restructuring still ahead for those companies. Some would say that the reason that there are so many private equity firms interested in auto is because they sense the market inflection point is near. Some are betting better times are ahead.

And yet all is not perfect. Not surprising that the UAW Chrysler deal is hard fought as many locals vote down the first agreement challenging the new owners for another round of concessions. The social contract for much of the developed world's working class, negotiated over the last 70 years by centralized, powerful labor unions to elevate their constituencies to a solid middle-class life is expiring. All this as low cost, skilled labor across the world is rushing to perform work as people in emerging markets pursue their own middle-class dreams. An existential crisis for unions in the U.S. And, in the future, Canada. And Germany. And Japan. And Korea.

From a market standpoint, maybe this is only a brief respite. Domestic automakers must still address the issues of market share decline, weak brands, holes in their product portfolios, the restructuring of their retail channels and the non-competitiveness of other-than labor costs. Domestic market share is down again in the first months of this year. Overall new vehicle sales may be slowing. Even Toyota suffered sales declines in the last few months. And a double whammy on the supply chain ... North America production may be under 15 million units this year for the first time in many years, down by over million units from only a few years ago. All numbers in a non-recession scenario. The UAW is right on one thing. Labor is only one of the strategic challenges.

More disruptive changes will surely come. We are just seeing the beginning of international capital from China, from India, from the Middle East and from Russia buying strategic assets in North America and Europe. Middle Eastern money in Aston Martin and Russian money in Magna are just the tip of the waves of capital globalization yet to come. These global players may play through private equity, maybe on their own.

I am not sure that the fabulous private equity world will go un-rocked in the future either. The lucrative “2 and 20” model may be under challenge. A recent Citibank survey of the top 50 pension fund managers, who collectively control roughly \$1 trillion or so, shows that 75% believe that the current hedge fund fee structure is not sustainable. In Europe, over 90% hold that view.

And some would say it is strange, that in a world where public U.S.-based companies are governed by Sarbanes Oxley and banks are still strictly regulated by government agencies, such significant private monies can flow so freely. Good or bad? Does individual-market-participant counterparty surveillance suffice as argued by Greenspan in his recent book? (*The Age of Turbulence*) Or will United Kingdom regulators lead the way for more transparency of the private equity black box?

So what does the future look like? Ahhhh. If I knew that I would be a very wealthy consultant. But allow me some last thoughts.

First, I believe that private equity will drive tremendous changes in the U.S. auto industry, not just within the companies they own but in heightening the pace of change for the entire market. Private equity manages two resources, their own time and other people’s money. Now that they have invested valuable research

time in understanding the global auto business, they will leverage that knowledge to make money. And they are definitely not done buying companies yet. But their pace has been slowed by the recent tightening of the credit markets. Highly leveraged deals won't be as easily financed as before opening the door for strategic buyers, now on a more level cost-of-capital battleground. Perhaps some of you are in the market for acquisitions as we speak.

Next, all established automakers need to up their game, not just the domestic manufacturers. As Chinese and Indian automakers flex muscles outside their home markets, competition will reach a new level of intensity. As we see lately, even the best, like Toyota, experience growing pains periodically. No one can ever develop the arrogance of believing that the Number One slot is an entitlement.

Third, innovation and absolute cost competitiveness define the winners. One of the most exciting areas of innovation is powertrain technologies. Who would have thought just a short time ago that oil would reach over \$80/barrel? And that being "Green" would become a brand imperative to market to the 21st century consumer in so many countries? Diesels, flex fuels, hybrids, electric vehicles and, someday fuel cells, will join more efficient gasoline engines in the race for the ultimate green machine. But innovation isn't reserved just for high tech areas. If breadmakers can continue to innovate the 6000 year old process, surely we in the car business can continue to rethink every aspect of the vehicle and the processes to bring them to the consumer. The new wave of under \$5000 vehicles will inspire such breakthroughs.

OEM's will continue to form alliances then divorce these partners as the world changes. I believe these relationships are better viewed as temporary affairs of

the market rather than permanent marriages of the balance sheet. Still, despite the expense to shareholders of certain separations, I look for new partnerships over the next few years, maybe even some surprises. Prenup's are definitely advised.

Finally, I would not be surprised to see more of you in the big time acquisition game along with other international companies, including gaining more confidence to play bankruptcy roulette. Or maybe you'll facilitate the liquidity event for the private equity money to flip their current investments in a few years after some of the heavy restructuring lifting is done.

In closing, I will share something personal you may not know. I am not an engineer by training. Actually, my university majors were Chinese history and Renaissance art, studies that my father, an auto executive, described as the ultimate in unemployable skills during the 1970's. Yet, as a young American in a young country like the U.S., I was drawn to China's 10,000 years of history --- her culture, her art, her people. Now that decision looks like foresight. Funny that now, so many of my countrymen think of China as an "emerging" market. Well, that is certainly not true in the auto industry with China passing Germany to become the #2 market in the world. So, as citizens of two global leaders, I hope that our economic ties will continue to strengthen to create a better world for tomorrow.

Thank-you.