# Manager's Journal It's Not the End of the Road for Midsize Car-Makers

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By Richard Miniter

Ford's $6.45 billion purchase of Volvo's car division touched off a round of hand wringing by automotive executives and industry analysts on both sides of the Atlantic. Nearly every observer seems to agree that the Ford purchase will spell doom for midsize car-makers as the advantages of economies of scale force companies like Peugeot, Renault and BMW to merge or die. DaimlerChrysler Chairman Jurgen Schremp predicts there will be just 10 independent car makers by 2002, down from 17 today. Ford CEO Alex Trotman foresees a "global dogfight" that leaves only five or six companies, most likely General Motors, Ford, Volkswagen, DaimlerChrylser, Honda and Toyota.

This forecast is based on textbook economics: Bigger companies can achieve economies of scale as the cost of producing each additional unit falls. Marketing and distribution costs, on a per car basis, shrink. Larger orders also give manufacturers greater clout to negotiate discounts with suppliers.

But there are several good reasons to question the assumption that economies of scale convey insuperable advantages. For one thing, realizing such economies can demand burdensome initial investments. When Ford bought Jaguar in 1989, it planned to share platforms (the car's underlying skeleton) between Jaguar and Lincoln. This required years of retooling and harmonization that cost Ford hundreds of millions of dollars. The Jaguar unit didn't start to show profits until 1995.

Likewise, when BMW bought Rover, executives counted on economies of scale to turn around the ailing British auto maker. BMW engineers were able to shave costs at Rover by saving on parts and by modernizing Rover's antiquated plants. But the sport-utility maker wasn't able to lower production costs sufficiently to deter rivals from entering the market. Mitsubishi and Nissan, building on existing car and truck platforms, were able to seize the lower end of the sport-utility market. Meanwhile Ford and Lexus lured away upscale Rover buyers. Today Rover isn't able to sell enough vehicles to cover its costs.

A well-managed smaller company can outwit a larger firm relying on economies of scale. After GM acquired a 50% stake in Saab AB in 1989, Saab used GM's clout to muscle discounts from suppliers and shifted some accounting and data processing to GM's larger infrastructure. But rivals -- including Volvo -- cut costs even more ruthlessly. Volvo CEO Leif Johansson has laid off more than 5% of the firm's payroll, including more than 6,000 workers in the last two years. Mr. Johansson also aggressively sold off noncore businesses (including a large stake in the drug maker Pharmacia & Upjohn) and poured the cash into streamlining his plants and equipment. He energetically sought out strategic partnerships with other European auto makers to cut component costs. In a decidedly un-Swedish way, he repeatedly told workers and reporters: "It is the bottom line that matters."

There are also diseconomies of scale: Larger firms can be too diffuse to be efficient. GM's Opel AG unit in Germany is a classic case. Executives in Detroit are notorious for making their underlings in Europe wait months for decisions and for imposing complex purchasing and quality-control rules. Manager's don't even have the flexibility to deal with absenteeism at German plants, a chronic problem. Opel's market share is shrinking, its profits are plunging, and its management is in turmoil. The problem: Global GM can't focus on one relatively small division. Little wonder Wolfgang Reitzle, who heads BMW's Rover division, says BMW has no plans to buy or be bought. "We don't want to be substantially bigger because that creates too much complexity in managing the sheer size."

The conventional wisdom is that companies that make fewer than two million cars per year, such as Renault and PSA Peugeot Citroen, are too small to be competitive. But this is nonsense. Volvo produces only 400,000 cars a year and is one of the world's most profitable auto makers. It sold its car division not out of desperation but to concentrate on its even more profitable truck business. "It is very possible to remain a profitable and specialized car producer," says Volvo Cars president Tuve Johansson. "Size does not correlate to profitability."

Midsize car-makers, in fact, have an advantage in seeking out niche markets. Big companies like GM and Ford use "global platforms" for almost all their cars. The Ford Escort is a classic example of this one-size-fits-all philosophy, in which the same skeleton is used to build cars in the U.S., Europe, Australia and Asia. While this technique cuts costs, it makes economy cars that are too big and heavy to sell cheaply in emerging markets like Latin America. Meanwhile, Fiat SpA excels by making smaller, cheaper cars that are just right for buyers in Poland, Russia, Brazil and North Africa. Fiat executes this strategy by ignoring the North American market.

One company that has the right idea is Honda. "For some companies, size is the key to survival. They see mergers as the only way to survive the coming megacompetition," Honda president Hiroyuki Yoshino told workers in his New Year's address. "Honda is not interested in growing bigger globally. Our goal is to become more competitive by staying in touch with the needs of customers, accelerating the pace of innovation, and increasing efficiency."

Mr. Yoshino sees a crucial advantage in Honda's relatively smaller size. "We must retain the speed, efficiency, and local market sense of a small company," he emphasizes. That's why midsize car-makers have more to fear from Honda than from their gargantuan rivals who wave their checkbooks and talk about economies of scale.

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