

When Size Isn't Everything

The Ford-Volvo merger is not the end of the road for medium-sized car makers, argues Richard Minitier. Bigger is not necessarily better in the global car market.

Australian Financial Review, News; Opinion, Page 16

18 February 1999

By Richard Minitier

Some call it "the global gobble", an industrial-sized game of PacMan in which the few will devour the many and leave only a handful of oligopolistic behemoths who can freely raise prices on cars, which will become a fleet of boring boxes on wheels. That's how critics view the merger of Ford and BMW, a possible combination attracting new attention this week.

Only two weeks ago, Ford's \$US6.45 billion (\$10.24 billion) purchase of Volvo's car division sent shockwaves through the global business community and touched off a round of hand-wringing by automotive executives and industry analysts in Europe, the United States and the Asia-Pacific region.

Nearly every observer seems to agree that the Ford purchase will spell doom for medium-sized car makers as the advantages of economies of scale force companies like Peugeot, Renault and Fiat to merge or die.

DaimlerChrysler chairman Jurgen Schremp predicts there will be just 10 independent car makers by 2001. Ford CEO Alex Trotman foresees a "global dogfight" that leaves only six car companies, probably Ford, General Motors, Volkswagen, DaimlerChrysler, Honda and Toyota.

If true, then the car industry consolidation is harbinger of doom for a broad range of manufacturing and commodity firms in such key sectors as oil, drugs, aircraft building and machine tools. The good news is that the bad news is wrong.

The doomsday argument stands on two legs: history and economics. In 1945 there were more than 40 major independent automobile manufacturers. Today there are 17. The glut of manufacturing capacity will shove these historical trends along at a faster clip.

There are two good reasons to doubt this vaguely Marxist view of history: the car glut is temporary and the global car market remains robust. As Brazil, Russia and the Asian Tigers recover, car sales will surge. In the long run, the growing middle classes in China and India will demand tens of millions of new cars.

The economic argument is more substantial: bigger firms are able to achieve economies of scale, when per-unit volume grows faster than per-unit cost. Thus higher output allows firms to spread production, marketing and distribution costs over larger volumes, thereby lowering unit costs.

Large batches also give manufacturers greater clout to negotiate discounts with suppliers.

These are real advantages. It is the next step in the argument where the doomsters go wrong. They assume the economies of scale are so beneficial to bigger firms that the days of medium-sized firms are numbered. There are several good reasons to question that deterministic assumption.

Economies of scale are not an automatic result of mergers, but must be earned through painstaking paring of redundant personnel, functions and processes.

When Ford bought Jaguar in 1989, it planned to share platforms between Jaguar and Lincoln. This required years of retooling and harmonisation 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 predicted that economies of scale would help turn around the ailing British car maker. Though BMW engineers were able to shave costs at Rover by sharing some BMW parts bought with the parent company's volume discounts, the sport utility maker wasn't able to lower production costs sufficiently to deter rivals from entering the market.

Even Japanese companies like Mitsubishi and Nissan, which don't enjoy the same economies of scale as BMW/Rover, were able to seize the lower end of the sport utility market.

Meanwhile, Ford and Lexus lured away upmarket Rover buyers. The result? Rover isn't able to sell enough vehicles to cover its costs.

Economies of scale don't compensate for the bureaucracy that comes with bigness. Consider GM's experience with its Opel AG unit in Germany: shrinking market share, plunging profits and management turmoil.

As the world's largest car maker, GM executives simply cannot concentrate enough on Opel to beat the much smaller BMW. Small wonder BMW's Wolfgang Reitzle recently told reporters that the company 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," he said.

The conventional wisdom is that companies that make fewer than 2 million cars a 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 car 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 specialised car producer and a niche player," says Volvo Cars president Tuve Johansson. "Size does not correlate to profitability."

What about the idea that mergers will give car companies the ability to raise prices or force homogeneous products on consumers? Don't bet on it. Companies that make look-alike products invite customers to go to smaller firms that understand their needs better. Honda realises this.

"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," Honda president Hiroyuki Yoshino said recently.

Yoshino sees a crucial advantage in Honda's smaller size.

"We must retain the speed, efficiency and local market sense of a small company," he said.

Honda and Volvo are examples that Australia's business leaders should study. The lesson? Don't fear the coming mega-mergers. The new giants will overlook profitable niches that the alert medium-sized business owner can profitably pursue.

Richard Minter Writes About Business Trends For Readers Digest, The Wall Street Journal, The Australian Financial review and other publications.

Copyright of John Fairfax Group Pty Ltd

(c) 2005 Dow Jones Reuters Business Interactive, LLC (trading as Factiva). All Rights Reserved.