

Vices in Good Times, Virtues in Bad Sin and Redemption in the Car Business

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Good evening everyone. Great to be here tonight to talk to all of you.

So, you are all restructuring gurus-in-training. Dreamin' about hedge fund futures or the \$1000 buck an hour fees of restructuring hooligans? There is a reason that hedge funds are named Cerberus, guardin' the underbelly of the restructuring beast! Trust me, if business has an underworld, this is it. And this is just the kind of game y'all should love. High stakes. Big players. Change business model, start with a clean sheet....albeit slightly soiled..., rewrite the rules kind of play. MBA heaven, if there is such a place. Or maybe restructuring is more like Purgatory....you have one more chance at salvation....for just a small penance.

So, now that you have slashed and burned your way through Delicious Delights, salvaging NoHo's for humanity while tossing Teamsters on the street, let's look at a real live case study playing out in the media today. My business. The car biz. Domestic automobile manufacturing. One of the giants, nay one of the goliaths of industries. And now, like steel and airlines before it, domestic 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.

How could this have happened? How could this tsunami crash upon 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 not just because of uncontrollable economic cycles. Unfortunately, the boom times seem to encourage our worst excesses—our greatest vices—our most grievous sins.

Sin. Oh, don't worry. You aren't in the wrong place. This won't turn into some revival dinner. After all, this is Northwestern and you are MBA's. Besides, everyone knows that you already don't have any souls anyway and if you do still have one it is probably for sale anyway. You probably have Gordon Gekko and the Donald shrines in your bedrooms. Besides, the word "sin" didn't used to be religious at all. It originally came from an archery term. It goes back to Biblical days. When an archer shot at the target and missed, the scorekeeper yelled the word "sin". "Sin"—in this original concept meant, "you're off the mark, your aim is not true, take another shot." The opposite of "bulls-eye".

Kinda like the auto industry in the good times. We sin a lot, you know. In the good times, our vices emerge. Vanity eclipses our collective memories. Free cash feeds our egos. We buy; we diversify. Intemperate and extravagant. Dissipate and delusional. Like fickle fools, we forget the formula that made us famous.

And then, like louche party-goers from a Saturday night, we awaken on Sunday morning to a headache, a hangover, high product costs, exorbitant legacy costs, a weak balance sheet, acquisitions that we have NO idea how to integrate into our core business and NO idea whose wise idea it was to buy "that stuff" in the first place. We are repentant and remorseful. We all swear that we will NEVER do this again. Besides, it wasn't really our fault. Like born again virgins, we arise and readopt the virtues that once made us successful.

Because, of course, we've seen this before, haven't we? We have done this already and we'll just do it again just like we did before and we'll be just fine....again, won't we? Isn't this just a contemporary replay of the 70's and 80's and the 90's? Can't we just depend on doing what we've always done to pull things through? Why, we'll come back to the same virtues that have always been core to the car business. Great product. Good quality. Oh, and we'll address that cost issue in the next restructuring plan, generation number five or ten or 50. Take out a few non-core plants... nothing that would make the unions really upset of course, lay off a few lower level salaried people...probably should do that every so often just to clear house anyway, pressure the supply base – there must be a drop of blood left. Oh and divest some of our crazy investments from the last upswing. That should do it, right?

And then came 2005. 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 the year of emotional convergence for the car business. Let's just bottom-line it. GM and Ford face-- at minimum -- serious out-of-court restructuring in the next few years. For GM, if they don't execute, they'll end up in 11. Period. And any settlement that absorbs a significant amount of Delphi obligation will make them just so much more vulnerable. And this recent restatement and tough October sales didn't help investor and consumer confidence any. The planned changes at GMAC will prevent material disadvantage for unsecured debtholders. There's clearly brand and consumer risk but there may be no choice for GM except bankruptcy.

Less likely that Ford would file since the Ford family would lose their special stock class and its associated rights set up in the 1956 IPO but a severe downsizing and potential alliance or sale are certainly not out of the question.

And suppliers. Delphi, Collins & Aikman, Federal Mogul, Tower Automotive, Oxford Automotive, Meridian, and most casting suppliers just to name a few that are in or recently out of 11. There will be more. Some are teetering as we speak.

So, what has really changed and what do we do about it?

The biggest thing – I am sure you have all studied it all in school -- 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 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. The Japanese and Korean automakers expanding production in NAFTA and Europe. I mean the surge in strength of new global players, especially China and India. I mean a consumer that 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. And for automotive suppliers, we are price arbitrated against other suppliers from Chicago to Shanghai and Sri Lanka. Sometimes one wonders if the automakers won't source to Pluto next if they could figure out the logistics. A new world.

I, personally, am a strong supporter of globalization. Generally good to be pro a world force that you can't do anything about anyway. But, I have 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. Great at the macro level --- in the classroom or in the press ---- but really tough for many companies and individuals who had planned their futures in a different time. The human opportunity is in a different place than the human toll.

Second, the demographics in the U.S. and the design of our health care and pension systems that deliver services primarily through a corporate model have combined to make U.S. companies, especially those with aging workforces and defined benefit plans uncompetitive in a world where global competitors simply do not bear these costs in the same way.

But, like it or now, the ramifications of these convergent waves are just beginning.

So, how do we right ourselves? What do we reluctant penitents do? First step. Absolutely necessary.

1) Face the facts head on. This is where, often in restructuring, outside professionals earn their hefty fees. The traditional constituencies led by management or existing Board's may too often look to history for answers. Or cling to sunk cost justifications in investments or people. Or value what is forever gone for too long. Or freeze like deer in headlights in the face of so much stress. But the most ruthless creatures on this planet are informed consumers with competitive choices. They will not pay for nor will shareholders subsidize waste. Less emotional, experienced outsiders can lend a clearer, less skewed view. In the end, the market seldom cares about yesterday. It only is what it is or will be.

In automotive, some thought that the early bankruptcies of certain suppliers, driven by commodity prices or highly levered balance sheets, were exceptions. Not really a tidal shift ... just anomalies. Tower was part of this early wave, one of the fortunate ones as we have been able to manage the process relatively smoothly so far. We had a new management team brought in over the last two years to try to turn the company around but we realized early this year that we needed court restructuring to deal with our balance sheet and liquidity issues. Matter-of-factly, among the first, we translated U.S. bankruptcy terms into German, French, Italian, Japanese, Korean and Chinese to explain to global automaker customers how American law allowed another path besides receivership or Chapter 7 in our parlay. I personally warned my many colleagues in the automotive business including at the large OEM's that this was only the first wave. They nodded sympathetically confident in their cocoon that they would not be touched by the restructuring

flu. A year ago, the possibility of a GM or a Ford facing bankruptcy was only whispered in side corridors of Detroit. The common thinking among OEM's and suppliers was that the majority of the base would pull out, narrowly missing a profound restructuring scenario. Just like in the 70's or the 80's or the 90's.

And so the rallying cries reverberated. Regroup. Round the troops. Back to Basics, Focus on the Fundamentals, Profit from the Core. Austerity, Abstinence, Accountability. Discipline. Martial law. Operational Excellence uber alles. The eternal salvation of new product. Maybe a few minor casualties but not the big guys.

All good stuff. Just not nearly enough. Delphi changed everything. The October filing of the largest automotive supplier, very well-respected for technologies and capabilities, stripped the idealism from the industry's eyes. Battle scarred in auto, airlines and steel and unafraid of C11 stigma, Steve Miller is leading Delphi through a restructuring process to deal with the company's structural issues unapologetically, unafraid, face to the wind, negotiating much of this plan in the press. Face the facts. This is an industrial pandemic where we will close unneeded or unprofitable plants, collapse distribution channels, reject unprofitable customer contracts, shed unsupportable debt loads and renegotiate the social contract with the highly-paid, unionized working class in our country. And we need to do this right to survive in the global marketplace.

2) Second. We must deal with the legacy costs associated with the domestic auto business. Legacy costs. It's easy to call them legacy costs because it helps divorce management and professionals and investors from the human reality. I do disagree with some professionals who postulate that auto is just like airlines and steel. Oh, there are similarities. High fixed costs structures with little flexibility. Huge legacy costs. Corporate goliaths who had lost touch with the competitive marketplace and now face a dramatically different business model gaining ground. Strong unions who have worked for decades to negotiate fully

fringed wages that allow their employees...all their employees without regard to the competitive market...to live a solidly middle-class life without working too hard. The result of decades of pursuing the American dream. All this negotiated with oligopolistic companies who could pass these costs onto their consumers -- in the good old days.

Like airlines and steel before, much of the new business model in the auto business is from within the U.S. The new domestics with investments in Kentucky, Tennessee, Alabama, Mississippi and Texas in highly productive, non-union plants with low legacy costs and generous state give-backs and warm weather despite a few hurricanes are the real ones winning. A Pogo-like joke with the enemy being in the mirror. In sales, the Big Three market share is close to the 50:50 split with import brands, a demarcation line many thought would spell the ultimate doom. But this year, even more surprising, the import brands will likely pass General Motors in North America production volumes. The new domestics of Toyota, Nissan, Honda, Hyundai and, likely in the future, Chinese brands are already expanding beyond manufacturing into R&D, engineering and product design, as well as philanthropy and sophisticated lobbying in Washington D.C. This is where the car world has really changed from the 70's and 80's even the 90's. The new business model is right here at home. Will our politicians protect Ohio and Michigan from Tennessee and Alabama? Or will the government will swoop in like it did for Chrysler in the 80's for GM and Ford? Not likely. How would that even be accomplished? Nope. This one will be played out in the marketplace.

But there are important differences between auto, airlines, and steel. Most important, the supply chain. One in seven jobs in the U.S. is still connected to the auto industry, most of this still to the domestic auto industry. The pre-petition debt in the car business is already in the billions and it is just beginning. The full domino effects of the next few years are like a tsunami in the middle of the ocean...swelling but not yet fully visible until the wave crashes to shore. This is still ahead of us. The steel companies had raw materials like iron ore and coal mines, early in the value-chain. And airlines play some kind of financial

shell game with mostly leased assets, rejecting leases in bankruptcy from the same financial providers that then turn around and provide DIP financing at LIBOR plus 900 – a great business....for GE. For the auto industry, the changes over the next few years will alter the economic landscape in the Midwestern part of the United States at the very least. Think Pittsburg --- times 100.

Plus, we are seeing a broader move from a capital versus labor struggle that really took social form in the Industrial Revolution shift to a much more level global playing field dominated by informed customers in open markets vying for value versus increasingly agile capital spelunking for profitability. Capital, increasingly dominated by hedge funds and private equity, behave very differently than your traditional, friendly banker. Low cost, skilled labor across the world is rushing to perform work as people in emerging markets pursue their own middle-class dreams. 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. An existential crisis for unions in the U.S. And, in the future, Canada. And Germany. And Japan. And Korea.

Last, the generational demographics will drive divisions between the exploding aging population and the smaller working population...your generation... especially in the U.S. where the country's lack of a national health care system and generous defined benefit have forced costs on corporations who can no longer bear the load. People are living longer. This is great. Phenomenal advances in medical science can offer decades of longer, healthier life but at a very high price. People who planned to work 30-and-out then live for 40 more years on generous pay will have to return to the workforce or to their families for support or face earlier death as extraordinary health care covers only those who can pay. Yet who should pay for these costs in our society? If the answer is no one, social turmoil will occur.

Wait, I know. Maybe the government can save us. Maybe all these pensions will simply be turned back to the PBGC...the Pension Benefit Guaranty Corp.... the fed. Maybe that's the ticket. "Society" can

pay. Oh oh. That really means the taxpayer. The PBGC, already staggering under deficit obligations of over \$23B from steel and airlines, is hardly ready to take on the auto sector's defined benefit plans underfunded by \$55B to \$60B combined. I do believe that the PBGC will play a more active role in the future especially as funding requirements for companies become robust, hopefully balanced by the PBGC's ability to negotiate covenants and payment schedules just like other financial institutions...changes that still need to be made at the federal level.

3) Despite the press attention on the labor issues, for some companies, especially automakers, dealing with the cost-side is not enough. Vehicles are the world's most complex, most emotional consumer products. Brand strength and great product are crucial. Lexus has got it. BMW minus Rover has got it. Mercedes, a great brand, lost it in quality for awhile but they're getting it back. Toyota, Honda, Nissan and Hyundai mostly get it. But General Motors and Ford are feeding too many weak brands dragged down by too many ho-hum products. Not all but too many to support. Chrysler is getting this closer to right with a more agile culture born in the toughest of days, a stronger product pipeline, faster development times leveraging Mercedes, a higher hit ratio, and lower structural costs, Chrysler is not exactly like the other two Big Three. Both GM and Ford have brands and, hence, dealership distribution channels that can no longer be supported. Oldsmobile's euthanasia is not enough. And the product pipeline in both companies is drier than for any other automaker in these next five years with a recent new product hit rate....well, I'll let you judge that for yourself.

To make matters even more challenging, the industry stands at the crest of a technological discontinuity in power trains. Precious investment needed for new vehicle models must also be accelerated in alternative power trains such as hybrids, diesel and fuel cells as the American public suddenly falls out of love with their huge SUV's and V-10's and goes eco-greenie in the blink of a \$3.00 gallon.

Overall, GM must restructure to be a 20% market share company and Ford must do the same thing targeting 14%. Maybe less for both. This has broad implications far beyond just labor. Both have a few

years and substantial cash but \$20B burns fast in a large company with high fixed cost structures and underfunded pensions. Maybe some things can be accelerated but not everything since cash flow is negative in the core automotive operations and significant monies will be needed for the restructuring ahead. Choices must be made to save the strong and flush the weak. Must face these facts too.

4) So what will they do to fund the fix? They'll have to shed all but the core and maybe some of the good stuff to fund healing the core. So what is core? Core is not what management likes or what the company used to do well. Brands and products and markets must be competitive and profitable or able to be made competitive and profitable or divested.

And some of the crown jewels will need to be sold to raise money to fix the core automotive business. You can see the automakers begin to divest: GM with GMAC Mortgage and, now, probably a significant share of Commercial Lending. Subaru sold to Toyota, divestiture of Fiat (the Italians are still celebrating); Ford with the Hertz sale; even DaimlerChrysler with the sale this week of their stake in Mitsubishi. Expect more. GM still has equity stakes in Suzuki, Isuzu, and Daewoo. Ford still owns Volvo, Jaguar, Land Rover, Aston Martin and a third of Mazda. Cash generation from the financial arms has declined as ratings fell to junk and money grew more expensive. Yep. More to come.

As suppliers, we too must scrutinize our portfolios and ask by customer by vehicle platform, what makes sense. What would actually happen if we only took profitable business instead of business designed to keep plants running at break even or less? The revenue-roll-up-without-profit days are over – at least for our business.

5) And for you financial jocks....better shore up the balance sheet. Leverage. I am not sure who thought that this would be a great sector for a long-term highly levered balance sheet. True, many made monies in the 90's as an expanding market fueled levered supplier companies but by early 2000's, the model should have been changed. In a highly cyclical, high fixed operational cost, low margin business (why do we love

this industry again???), high fixed financial costs simply cannot be supported over time. If necessary, at an acquisition, the first goal must be rapid integration and the realization of synergies to pay down debt to become strong again. Many automotive suppliers fell into this trap. Management, driven by revenue growth and short-term P&L performance, forgot to watch balance sheet health. Even experts paid. While some financial backers got out at the right time earned their returns, many smart people got burned.

6) And finally, one more important ingredient. No. Not hours of inter-company payable analyses. The People. The people who lead the company and the triage experts who help fix it. Leadership and Relationship skills. The courage of some people to surf the tsunami, to pull it all together and pull it through. Because it is not only about decimal places and leverage ratios. Those are just the mechanics. To create sustainable value in uncertain times – and, of course, there have never really been any other kind of times -- the essence of why the business deserves to exist must be captured. The Vision. The magic. The soul. (Bottom line: that means that management never works for less than 10%.)

If you're lucky, there will already be strong leadership in the company although more often new leadership or temporary mercenaries can turn the tide. For the long-term, you'll need more committed players. Leadership in winning organizations goes beyond the basics to infuse the company with a vision of victory, to articulate a *raison d'être*; a *pour quoi*. Not just for colleagues (those left standing) or customers (always a good thing) but even for the unsecured investors whose only prayer of some recovery lies in the successful realization of a plan that works.

In restructuring, in court or out-of-court, somehow it must come together or end up in 7. Each party must sacrifice. Most won't like it. And somehow, it must come together to exit and go on. Professionals play a tremendous part in these negotiations. Hire the best and make sure they play well together. Hire someone that the other side respects. Many of the deals are cut in hallways, sealed by relationships that bridge much more than any one company or any single deal.

The car business. If any of you are New Yorkers, you probably don't care much. If you're Californians, you may not notice the difference. Imports already dominate the roads. Many of you are probably from wealthier families, it all may seem distant. Just for the working classes. After all, most of the country is still clipping at a healthy near 4 % growth rate. You'll live in a smile state and work for hedgies or high tech. Many other sectors are doing quite well, thank-you. All true.

But these changes will be broader than we have seen before. Farmers faded gently into that good night protected by trade restrictions that still exist and paid millions in subsidies not go grow anything. Bribes, still in effect today, smoothed the transition into the industrial age. Who will pay the industrial worker the same way? No one. And since, unlike farmers, the industrial worker is organized by the UAW, the AFL-CIO, the Teamsters, they will not go quietly.

For a generation of young boomers and Gen-X'ers, independent since adolescence, aging parents whose health care benefits and pensions no longer cover minimal needs will move back home...physically or financially. I don't know about any of you but I am not necessarily looking forward to this personally.

Look at the political battles ahead. Michigan and Ohio are swing voting states. And even the most recalcitrant politician will listen to the AARP since their members all vote. Already, some politicians in both parties are sounding protectionist tom-tom's although this is old world as well.

The changes will happen. Bloody but inevitable. They will happen. And, while companies will come and go, ownership will change, CEO's will cycle through in five-year half lives, somehow we'll figure it out.

So why would someone stay in the car business? Why bother with the restructuring ahead? Gasoline in our veins? Maybe. Institutional insanity? Almost certainly. But there is another reason. When the car business "gets it right," you can literally "see and touch, and feel" the end result. The product "sings." And the public listens. That's why it worth restructuring. To get healthy again. So that we can create those "moments" when it all comes together.

Jaw dropping, take-your-breath-away, high-five moments when the “music of the spheres” trickles into sheet metal, glass and chrome. Like when the Spirit and Soul of our business are captured in cars that, define generations -- that people celebrate in songs and that provided the key product that fueled the rise of e-bay. You know Spirit and Soul when you see it embodied in a great vehicle. You may not remember the marketing campaigns of the cars of 40 or 50 years ago, but you just look at those vehicles and you know that a group of people “got it” -- they got the basics and the essence -- and you can still feel all the love that had to have gone into the vehicle at the time.

The very emotion that can blind insiders to its flaws is the very reason the car business deserves to be fixed. That’s the romance. The reality is that the bottom line must work too.

So, maybe when some of you get out, you can join us. But hurry! The next few years are going to be an interesting ride!!

Thank-you.

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