



How to Fix GM

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For more information on this topic, see our [interview](#) with Patrick Anderson in this issue.

The greatest threat to the American economy is now the fragile state of the automobile industry, particularly General Motors.

A recent study by the Center for Automotive Research suggests that a 50% contraction of the US Big Three manufacturers would result in an immediate loss of 2.5 million jobs, assuming the balance does not get picked up by foreign companies. Of these, "only" 239,000 would come from the auto companies themselves, with the rest coming from suppliers and businesses affected by the reduced spending of those employees who were laid off. Such massive job loss would push the unemployment rate from 6.5% to approximately 10.5% and cause a \$125 billion decline in personal income, reducing the GDP by 1%.

Before you jump to the conclusion that such forecasts are industry and union hyperbole, keep in mind that other surveys suggest that up to 90% of consumers would not buy from a bankrupt automaker. A substantial contraction of GM – a scenario that is all but inevitable – would have damaging repercussions throughout GM's supplier chain and dealer network.

One of the lessons of the credit crisis is that systemic failures have effects that are more severe and unfold more rapidly than we tend to anticipate. GM will have less than \$5 billion in cash by late December and this cash level "could be overwhelmed by payables coming due in early January," according to Rod Lache of Deutsche Bank. GM is on the brink, and, although Ford and Chrysler may be in better shape, GM's failure could make Lehman's bankruptcy seem like a hiccup.

Leaving aside the "bailout versus bankruptcy" debate, it is a different, very specific question that will determine the ultimate fate of GM: What will it take for GM to break-even in the current low-demand environment?

This is the same question lawmakers asked the auto executives in Washington this week before sending them back to Detroit with two weeks to find an answer. We don't know what the rescue plan will ultimately look like, but Lache's analysis allows us to paint a general picture.



The Big Picture at GM

Simplifying the economics of GM's business is not easy. They are a large multi-national corporation with multiple product lines, complex labor agreements, legacy costs, and regulatory issues that restrict their ability to maneuver. Their economics are also a moving target, as the abrupt changes in consumer buying patterns earlier this year — an accelerant of their current crisis — demonstrate.

GM burned through approximately \$16.6 billion in the first nine months of this year, according to Lache, including \$8.5 billion in cash during the third quarter (some of which was a non-recurring restructuring charge). Reports indicate that GM is currently burning cash at a rate of \$2 billion per month.

Assuming GM's revenue for 2008 ends up at \$150 billion, its challenge is to trim expenses by about \$24 billion per year. Some of these reductions will come from fixed costs, and others will come from variable costs as production decreases.

For his projections, Lache assumed that US auto demand will be 13.5 million units for 2008, declining to 12 million in 2009 and then rising to 14 million as the economy recovers in 2010. By contrast, between 1998 and 2007 US vehicle demand hovered between 16 and 18 million units.

GM has already slated approximately \$9.2 billion in additional cost-saving measures, as follows:

- \$2.7 billion from an 18,000 person hourly headcount reduction
- \$1.4 billion from salaried headcount reduction, elimination of salaried healthcare, and executive bonuses
- \$2.4 billion from a reduction in 2009 capital expenditures (from \$7.2 to \$4.8 billion)
- \$2.7 billion from a reduction in healthcare benefits

But these still leave GM in a position to burn \$10 billion in cash annually in 2009-2010, assuming – conservatively - its market share declines from 22% to 20%.

Lache says two drastic steps are needed to get GM to a break-even level:

- **Brand Line Reduction:** GM currently has eight brands (Chevrolet, Cadillac, Hummer, Saab, Buick, GMC, Saturn, and Pontiac). Lache estimates that reconfiguring to a “more defensible” core brand structure of three brands (Chevrolet, Cadillac, and Buick) would lower GM's fixed costs by \$5 billion per year. After this reconfiguring, GM's product line would be comparable to that of Toyota or Honda. Such a



reduction would also dramatically reduce the number of GM dealerships (currently approximately 7,000), although it is not clear whether it would reduce them to Toyota's level of 1,500 dealerships.

- Move All Tier 1 Employees to Tier 1.5 Status Immediately:** GM's 2007 labor contract defines three categories of workers: Core/Tier 1, Tier 1.5, and Tier 2. A summary of labor costs for these tiers, along with Toyota's costs for comparative purposes, is below:

Figure 15: GM / UAW current and prospective wage structure (compared to Toyota)

	2007 GM	2010 Proforma			Toyota
		GM Core/Tier 1	GM Tier 1.5	GM Tier 2	
Wages +COLA	\$28.12	\$28.12	\$25.00	\$15.30	\$25.00
Overtime	2.81	2.81	\$0.00	0.00	3.75
Vacation/holiday	6.55	6.55	\$3.90	2.30	3.75
Up-front bonus	1.44	1.44	\$0.00	0.00	1.25
Other misc.	4.23	4.23	\$1.75	0.00	0
Total wages	\$43.15	\$43.15	\$30.65	\$17.60	\$33.75
Benefits					
Pension	4.19	5.88	1.00	1.00	3.38
Group life	1.27	1.27	0.27	0.27	1.25
Healthcare +OPEB	17.34	6.08	6.08	3.50	5.29
FICA & UC	3.23	3.23	2.50	1.75	2.88
Other misc.	1.66	1.90	0.00	0.00	0.71
Total benefits	\$27.69	\$18.36	9.85	\$6.52	\$13.50
Total labor cost per hour	\$70.84	\$61.51	\$40.50	\$24.12	\$47.25

Source: UAW, Company Reports, Deutsche Bank estimates

Starting in 2010, all new hires for "core" (assembly) jobs will be assigned to Tier 1.5, and new hires for non-assembly jobs will be assigned to Tier 2. Also, in 2010, retiree health care costs are moved to a separate entity (known as VEBA) that reduces the costs of core/tier 1 employees.

Lache says that moving all Core/Tier 1 employees to Tier 1.5 immediately (or in the very near term) would save GM \$2.6 billion per year. The chart above shows that the primary effect would be a loss of overtime, vacation/holiday pay, up-front bonus, and pension benefits for the affected employees. Most importantly, it would put GM's blue collar healthcare costs on a par with those of its non-US competitors.

These two steps, in addition to GM's already planned reductions, would bring the company to a break-even level based on US demand of 12.9 million, just above the level projected for 2009 but below that of 2010.



Implementing such a plan faces enormous challenges. Dealerships are protected by state laws and may require buyouts to close. The organizational challenges of a brand-line restructuring of such a magnitude would be unprecedented in American industry. One-time capital expenditures would be necessary for plant closures. GM's pension liabilities would have to be restructured and settled. Lache pegs these costs at a minimum of \$20-25 billion.

But the greatest challenge would be the union concessions required to move all Tier 1 employees to Tier 1.5 status.

The UAW will be asked to make additional concessions, beyond moving employees to Tier 1.5. GM must modify the work rules in its union contracts, which put the company at a severe disadvantage vis-à-vis its non-US competitors. These rules, for example, stipulate how many workers must perform certain functions. Worker hours are tied to production output; so when a certain number of vehicles are processed in a day, workers can go home. GM is thus prevented from speeding up its production line without paying workers overtime. GM's Jobs Bank program – which contains the perverse incentive of paying workers not to work – must also be eliminated.

The sad reality is that blue collar workers bear virtually the entire brunt of these changes, even though GM's management failed to make these changes and are thus responsible. But no degree of leadership change can correct the economic imbalance destabilizing GM's business.

Patrick Anderson, CEO and founder of Anderson Economic Group in East Lansing, MI, consults with all three automakers on the economics of their business. In an [interview](#) with Advisor Perspectives, he said, "There is a very profitable GM contained within the current edifice. However, getting from the GM of 2008 to the GM of 2010 is going to be very difficult."

But it is not impossible. Bringing GM to break-even requires extreme and drastic changes. But allowing GM to continue on its current trajectory may be even more extreme and drastic.

Some will say that these changes cannot happen. But that attitude is exactly what got GM to this precipice.

Unless we want to permanently subsidize GM at the taxpayer's expense, a profitable GM of the future will look very different from the cash-burning GM of today.



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