Keeping the West Michigan Auto Industry Strong

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West Michigan auto parts manufacturing has entered what appears to be a period of long suffering: plant closures, lay-offs, and once profitable businesses moving south in search of lower operating costs. New grim announcements occur with apparent regularity on the evening news. There are, however, a number of companies in the region that continue to be successful, that are growing and capturing new business at a profit.

In this article, I will attempt to provide insight as to how the auto industry arrived at its current state. Then, drawing on the experience of those who have managed to survive thus far, I will make some suggestions as to strategies local parts manufacturers may want to employ to best insure survival, if not unconditional success. I will cover

- the loss of demand volume from parts suppliers’ traditional customer base,
- the influx of the New American Manufacturers (aka “Transplants’), primarily into the southern states,
- the intensity of the price, cost, and profit pressures being felt by auto suppliers resulting from industry consolidation and intensified competition,
- the resulting rapid improvement in productivity, and
- the diminished “cluster advantage” of the West Michigan region.

Market share losses mean lower component demand

Failure by the traditional domestic automakers as far back as the late 1950s to understand and satisfy U.S. auto buyer needs opened a wide door to competing carmakers from both Europe and Asia. The traditional Big Three first came under pressure from Volkswagen imports during the late 1950s. The dual oil shocks of the 1970s enabled Japanese makers, including Toyota, Honda, Nissan (Datsun), Mitsubishi, and a number of smaller players to gain a foothold as the Big Three found themselves totally unprepared for the gasoline shortages. The story is well known and will not be repeated here.

What may not be as generally well known is how a series of marketing miscues triggered another steep decline in Big Three market share in 1998, a decline still underway as of late 2004. General Motors, Ford, and the then Chrysler corporation were successful in holding a U.S. market share that cycled around 70 percent during the early- to mid-1990s through 1997.

Beginning in 1998, the Big Three’s light vehicle share began to plummet from 70 percent to its current level of 56.6 percent, year-to-date through November 2004. To put this in perspective, a thirteen percentage point decline in U.S. market share is equivalent to eliminating the need for over nine vehicle assembly plants operating at a typical 225,000 units per year rate.

Shrinking demand for the traditional customer group has been devastating to suppliers who have, for the most part, limited their sales to that market. A supplier selling a single component used on every Big Three vehicle sold in the U.S., for example, shipped 10.7 million units in 1997. As of 2004, the same supplier has seen an 11.2 percent reduction in sales to not quite 9.5 million units. Obviously, standing still with respect to maintaining the same customer base with the same content level per vehicle is not a growth strategy. Yet many auto parts suppliers, particularly small- to medium-sized firms, found it difficult to diversify away from Big Three customers during the ‘90s for a variety of reasons.

There are several reasons for the market share decline, but the onslaught of attractive new product brought to market by Asian and European makers has had the greatest effect. In spite of huge sales incentives that began immediately following the 9-11 attack, the traditional Big Three have been unable to stop the losses in market share. Their incentive spending has been averaging near $4,000 per vehicle sold, while Japanese brand incentives average less than a third that and the Europeans about half.

The battle to stem the decline in sales by the Big Three further exacerbated margin stress on suppliers as the automakers pushed hard for “cost give-backs.” The importance of price varies from one automaker to another. Commodity vs. differentiated pricing is clearly evident in how a General Motors goes to market compared to BMW or Honda.

The Southern Shift

Assembly capacity in the U.S. has been shifting southward since Nissan opened its Smyrna, Tennessee plant in 1983 and Toyota built its Georgetown, Kentucky plant in 1988. Auto plants have long been spread throughout the U.S. with facilities as far apart as Massachusetts, Louisiana, Texas, southern California, and Minnesota. Foreign car companies entering the U.S., however, have seemed to be especially attracted to regions outside the Great Lakes states.

Volkswagen, the first “transplant,” chose Westmoreland County, Pennsylvania for its U.S. assembly location, based largely on an unprecedented economic incentive package offered by state and local government authorities. A pattern was established where local boosters bid intensely for each subsequent auto plant.

Foreign manufacturers have, for the most part, avoided states with high manufacturing wage rates and a strong union presence in favor of states with an available labor pool of trainable workers to whom a $15-$19 per hour wage rate and good benefits would have previously been an unachievable dream. The New American Manufacturers have also benefited by hiring a younger workforce that significantly reduces their healthcare liability.
In 2001, 39.5% of U.S. light vehicle production capacity was located in the Great Lakes states (including MI, OH, IN, IL, WI, and the Windsor area in Ontario, Canada). Another 18.6 percent was located in the southern region of the U.S. including Texas. By 2009, however, the Great Lakes states will house only 33.7 percent of U.S. capacity, while the southern states will have 27.8 percent.

This creates a dilemma for auto parts suppliers located in the Great Lakes area as they lose competitive advantage on two counts: one, the lower direct labor costs of the South and, two, the lack of just-in-time (JIT) capability (not to mention increased shipping costs) when selling to southern customers.

To be sure, not all auto components require JIT. Scale economies would make the manufacture of some parts difficult to produce in small plants adjacent to or near vehicle assembly plants at which they are required. Engines and transmissions, for example, require a large fixed cost investment and are usually shipped to several plants and installed on more than one vehicle model.

Gentex, the Zeeland, Michigan automatic-dimming mirror manufacturer, has thus far been able to supply its worldwide customers from its home-based three plants. The company does maintain an extensive sales and engineering network in all of the major automotive producing regions but has been able to ship its high value-added product from a globally central location.

Cost downs
It is not unusual for a supplier's Big Three customer to demand a 25 percent price reduction over a three-year period backed by a threat to “move the business overseas.” The loss of pricing power by suppliers directly results from a similar loss by their customers. Unable to lower their own fixed costs in line with pricing requirements, the Big Three have applied draconian pressure to their suppliers.

To illustrate the extent of the problem, a typical price for a pair of sun visors for a “commodity” level vehicle sold to domestic automakers was about $22 a pair in the early 1990s. By the mid-90s, the market price had fallen to about $15 a pair, and today it is well below $10. Attempting to maintain production at West Michigan, direct labor costs is a losing proposition, as Johnson Controls found out, finally being forced to close its Holland area plant in 2004.

For an average auto parts supplier, direct wages comprise only 15 percent of total costs. On average, then, in order to reduce total costs by 1 percent, a supplier would have to reduce wages by 6.67%, given no change in productivity. Reductions to that extent are difficult, if not impossible to attain, all else held equal. Relocation to lower-wage-cost countries like Mexico and China become an easy choice.

Industry consolidation both at the automaker level and what is referred to as the “Tier Ones” (large system suppliers) has contributed to the pricing pressure. Today, only nine automakers produce over 77 percent of the light vehicles made in the world (nearly 60 million annually). The market environment is one with a limited number of buyers that hold inordinate control over their suppliers. An economist calls a market with few buyers an oligopoly. Each customer is likely to represent a large portion of a supplier’s sales, and there are few alternatives should a supplier choose to go elsewhere.

While direct labor cost is an issue, flexibility is more of an issue. In order to offset relatively high wage rates with productivity improvements, parts suppliers must be unconstrained from rigid contracts governing the flexible use of labor. West Michigan auto parts manufacturing has historically enjoyed a competitive advantage over its Detroit-Flint area counterparts, thanks to a lower incidence of union militancy.

One of the main reasons (there were others) that Grand Rapids lost the Bosch plant along with 1,200 jobs was the inflexible stance of the United Auto Workers union. There are several examples where union representation has not impeded increased flexibility and productivity improvements. American Axle & Manufacturing in Three Rivers is a good example.

Productivity improvements are driving job losses
U.S. employment at automakers and their suppliers has declined from a high of 1.34 million in June 2000 to 1.11 million in October 2004. Anecdotal evidence would suggest that the majority of the more than 200,000 jobs lost was caused by productivity improvements verses shipping jobs outside the United States. Successful and profitable suppliers continue to restructure their operations to do more with less, cutting labor costs while increasing unit output. The recently announced reductions at Johnson Controls in Holland are a good example.

Total workforce reductions also are occurring as the result of the shift in vehicle manufacturing from the traditional Big Three to the New American Manufacturers, as the latter are more likely to buy components from the U.S. operations of their home country suppliers. The “transplant suppliers” are likely to operate with a much leaner workforce at a higher level of productivity.

As the transplant suppliers have entered North America with high quality product and a lower cost base, the Big Three also have increasingly bought more of their components from them. A recent highly publicized example is the awarding of the “rolling chassis” contract for the new Toledo Jeep plant to Hyundai Mobis verses the Chrysler Division’s prior supplier, Dana. Although specific employment data are not available, it is expected that the Hyundai operation, while it will employ U.S. workers, will support fewer than Dana would have if it had landed the contract.

Up against the “Detroit Cluster”
Innovation in manufacturing technology has largely diminished what Michael Porter calls a “cluster competitive advantage” for West Michigan. Increased capital investment in physical plant and equipment, standardization of processes, and increased worker productivity have reduced the demand for “craftsman-type labor” in component manufacturing. Subsegment businesses of the auto parts industry where unique labor skills are required are either single company businesses in
West Michigan, leather tanning, for example, (negating any cluster advantage), or are in an industry segment under severe excess capacity and profit pressure, as with tool and die making.

A strong cluster has developed in the area within a 50-mile radius of Detroit, the center of design, engineering, and purchasing for many of North America’s automakers. In this telecommunications age, it may seem strange that geographic proximity still matters. After all, it is only a little over a two-hour drive to most Detroit-area locations if a face-to-face meeting is required. Industry participants do, however, see a significant advantage to centering a critical mass of human resource talent within the Detroit area. The need to “co-locate” within quick physical access to customers has become even more important than selection of a nearby manufacturing site. West Michigan, unfortunately, is also losing ground in this regard.

**Strategy recommendations**

Anyone working in the auto industry will freely tell you how tough it is to succeed in the automotive supply business. Given the hyper-competition of global business, however, you could say that about nearly every industry. In order to survive and succeed, there are well defined strategies that West Michigan suppliers must employ.

First, while it may seem radical and “cold-hearted,” the focus should be on employing highly skilled and educated knowledge workers. It is a myth that America’s economic strength is centered in manufacturing. According to the Bureau of Labor Statistics, manufacturing employment has declined steadily as a percent of non-farm employment, dropping from 31 percent in 1949 to only about 11 percent today. Microsoft, with its market cap of nearly $300 billion, ranks consistently among the top three most valuable companies in the world. General Motors, with a market cap of only about $21 billion, has consistently ranked as one of the largest destroyers of economic wealth, as it invested tens of billions of dollars over the last three decades and earned returns less than its cost of capital.

Loss of manufacturing jobs is a social issue that the auto industry cannot directly address. In order to remain in business, auto parts suppliers must at least earn their cost of capital. New investment must be carefully scrutinized to be certain that it will be creating value.

Second, and this is obvious, provide every incentive for innovation in the area of product offerings. Gentex may be the most striking example of success in this regard, but should the reader take the opportunity to tour other local companies, they will most certainly be pleasantly surprised at the new product ideas working their way to market. Most suppliers have been understandably obsessed with process innovation aimed at lowering costs. Experience has shown that innovation to offer differentiated products stands a better chance to build competitive advantage in an industry with such intense rivalry among participants. And, while it is certainly self-serving to say so, West Michigan has outstanding educational institutions that can contribute to the fostering of innovation.

Third, parts suppliers need to redouble efforts to add customers that are less price sensitive. Yes, they are all price sensitive, but some are more likely to allow a profit margin to suppliers of parts with characteristics that can be differentiated at the consumer level. It is no secret that Tower Automotive’s financial difficulties are to some degree the result of its dependence upon Ford as its largest customer.

Fourth, while it may be considered noble to keep manufacturing jobs in West Michigan, regional suppliers in many cases must consider locating incremental operations elsewhere in order to meet customer requirement or to take advantage of substantially lower factor costs. As emphasized in the first point, value creation is most likely to come from the functional areas of program or project management, design and engineering, which can be retained in the region. The manufacturing age has passed. We need to work to keep the right kind of jobs in West Michigan.

By following an agenda of disciplined strategies, West Michigan auto parts suppliers stand an excellent chance of profiting in the coming years. It’s a tough business, but show me one that isn’t.

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1. Please note that “light vehicles” referenced throughout this article, which include passenger cars and light trucks as opposed to medium- and heavy-trucks. The category light trucks includes pickups, sport utility vehicles (SUVs), and various sizes of vans.
2. American Motors (AMC) was a viable, yet much smaller player until it was sold to Chrysler in 1987.
3. The author generally refers to firms with less than $75 million in annual sales as small. Medium-sized parts firms range upwards to about $750 million in annual sales.
4. The plant closed in the 1980s due to a decline in VW sales in North America.
5. The Great Lakes region is not alone in suffering from a geographic shift of production. Western Europe has lost a considerable portion of its automobile manufacturing to Eastern & Central Europe since 1990.
7. Although the companies’ competitive position is enhanced by holding a large portion of North American capacity in a very capital intensive industry sub-segment.