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The Canadian Automotive Industry is *Not* in Crisis

While leafing through Auto Trader a few years ago, I was struck by a particular advertisement's transparency: "1991 Honda Accord, air, auto, no frame damage, mint, etc." My BS detector immediately blinked on; the straightness of a car's frame is one of those normally unmentioned features, like "unexploded airbags." The very fact that it's mentioned prompts questions about its veracity.

I mention this little anecdote because there has been some talk in the mainstream press about the Canadian auto industry being in crisis. I'm going to tell you otherwise, but when I say that our industry is not in crisis, I'm not skirting the truth. Yes, there are areas of concern, but I'm not being the disingenuous used Accord owner, telling a lie in the face of contrary evidence. What I am doing is drawing a conclusion based on facts, numbers, and more than three decades of experience in this business.

"Crisis" is a serious word deserving of a serious definition. The discipline of Conflict Theory teaches that certain conditions must be met in order for a group to believe that they are in a crisis situation. The parties involved must have the following perceptions:

a) The perception by decision-makers of a higher-than-normal threat to basic values.
b) The perception that there is finite time to respond to the threat.
c) The perception that before the threat has been overcome, there is a higher-than-normal likelihood that the resolution will involve some blood on the floor.

Given these conditions, you can argue that some OEMs are in crisis. You can argue that certain entities in the supply chain are in crisis. You can perhaps argue that certain regions are in crisis, and you can certainly argue that the unions are in crisis. It is reckless, however, to say that the Canadian auto sector as a whole is in crisis. This is the difference between twenty campfires and a forest fire. Yes, our industry is going through a period of change, but most of the macro-level indicators show no signs of crisis. In fact, the most important indicators show that we are doing well.

It helps to examine the individual components that comprise the automotive sector in order to understand the industry's relative stability. What follows are capsule overviews of new vehicle sales, vehicle production, manufacturing employment, and capital expenditures.

New Vehicle Sales

With the past summer's incentive wars behind us, it's easy to say that the market overbought itself. October was a difficult month for GM, Ford, and DaimlerChrysler, as they experienced widespread and painful withdrawal from incentivized pricing. October 2005 saw incentives drop to levels last seen in March 2003, and the results were predictable: massive year-over-year sales decreases.

The leaders of our Detroit-based industrial giants clearly perceived some threats - in fact, they likely perceived all the crisis warnings: threats to basic values, time pressure, and the

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possibility of dramatic change. In response, incentive levels are back up. November showed an incremental step in the wrong direction, and anecdotal evidence suggests that December is a negative indicator for those who wish Detroit could break from its cycle of 'profitless prosperity.'

On the flip side, Toyota, Honda, BMW, and Mercedes-Benz performed brilliantly this fall, and they did so with far less per-vehicle incentive money than their American competitors. It is the increasing dominance of import-nameplate manufacturers that will allow for the maintenance and growth of Canadian new vehicle market volumes.

Looking forward, we can expect the market to sustain itself around 1.5 million units per year for the foreseeable future. Is this cause for crisis? Barring 2002's jaunt up to 1.7 million, the market has been stabilized in the area of 1.5 million for five years. The lack of growth warrants concern, but it’s not alarming. This could, in fact, be the beginning of a cyclical downturn - a regular market 'correction' that occurs once or twice every decade. The sales slide is no steeper than those experienced in the past.

This is fundamental: it is important not to confuse a cyclical downturn with the market's structural integrity. The boat may be slowing down momentarily, but it is not taking on water! When examined with a long term lens, our forecast shows that the current decade will eventually represent about a 20 percent increase in sales over the previous decade, with an accompanying ten percent increase in production. This forecast could be high or low by two or three percent, but it is reasonably accurate. The only worrisome element among the market's structural variables is the production-to-sales ratio. Offshore imports will continue to climb in popularity and market clout, so whereas North American facilities produced 88 percent of the vehicles purchased here during the nineties, that number is likely to settle around 80 percent in the coming years.

In sum: strong market, structural stability, and some unease on the horizon but nothing beyond what has already been experienced. No crisis.

New Vehicle Production

As I write this in the early days of December, Canadian light vehicle production is on-target to hit nearly 2.7 million units (the forecast shows a disparity of just 315 vehicles between 2004 and 2005). This is the highest production total since 2000. If the anomalous season of 1999-2000 is excluded, 2005 can be regarded as one of the best-ever production years.

Yes, GM has cancelled a line from their Oshawa complex, but the capacity being added by "New Domestic" manufacturers makes up for it. Production is expected to hold steady around 2.65 million units over the next few years, possibly rising ever slightly by the end of the decade as Toyota's new Woodstock facility comes on-line. It is indeed of concern that we have not grown our North American production share appreciably within the past decade, but we are holding onto what we've got. Additionally, our continent-wide production share of “New Domestic” vehicles is now in-line with that of the wider industry, both figures holding at just above 16 percent.

How is this a threat to our industry? If one of our basic values is "more cars," then we should be rejoicing. Indeed, all of the criteria for crisis perception are located within the specific orbits of GM, Ford, DaimlerChrysler, and the CAW. These four organizations, interrelated as they are, project undue influence on the media's reporting of the state of the industry. However, to paraphrase and reverse an old saying, "What's bad for GM is not necessarily bad for the industry."

In sum: production is stable, and although there is movement between players the situation is manageable. No crisis.

Employment

If there is any area in which crisis is not evident, it is employment. Despite GM's recent announcement of Canadian cuts, the current numbers will be sustained or grown through the expansion of import-nameplate OEMs and their supplier base.

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Between 1995 and 2005, the automotive assembly sector shrank from 56,051 to 49,553 jobs, while the parts sector grew from 77,130 to its current 98,766. Total Canadian automotive manufacturing employment has grown about 11.5 percent over the past decade. We have lost a number of plants over the past two decades (GM - St. Therese, GM - Scarborough, Volvo - Halifax, Hyundai - Bromont, Ford - Oakville, DaimlerChrysler - Windsor), but the Detroit-based automakers have invested heavily to increase capacity at their remaining facilities.

Lower employment in the assembly sector is actually productivity-driven, not crisis-driven. It now requires fewer workers to build any number of vehicles, and capacity has not suffered as a result of today's slightly lower employment figures. This is good for the OEMs, the industry, and the buying public, as each vehicle produced here has less overhead production cost built into its price.

That said, it's apparent that the unions are in a crisis situation. We have lost about 15 - 17,000 union jobs while picking up about 40,000 non-union jobs. The world is changing quickly around the CAW and the basic values of postwar unionized labour are in jeopardy. The encroachment of the "New Domestics" adds time pressure, and the success of these "New Domestics" increases the likelihood of hot conflict.

Employment in the OE parts sector has declined by about 5,000 workers over the last two years and I'm concerned about this but we also know of dozens of overseas suppliers considering Canada for investment.

In sum: net positive employment growth. No crisis.

Capital Expenditure

There's no better indicator of future industrial health than capital expenditure. A company that invests hundreds of millions of dollars in *anything* is clearly thinking about the long term, and Canada has a long list of companies doing just that.

Whereas Canada regularly attracted around 15 percent of new North American automotive investment in the early-to-mid 1990s, we now average around 20 percent. In 2004, nearly 3.2 billion new capital investment dollars flowed into the Canadian automotive sector, and the 2005 total is likely to be closer to $3.3B. We have been at or above the $3B mark for over a decade, and with the OEMs' current plans, it is reasonable to predict that number rising to a consistent $4B-plus over the next decade.

GM's $2.5B "Beacon Project" was unaffected by the recent cutbacks. Not only does this program represent improvements to GM's existing physical infrastructure and increases in its traditional employment base, but it also embodies a new direction for GM's Canadian operations: capitalizing on Canada's outstanding intellectual capital. Among other significant investments, GM has founded the Automotive Centre of Excellence at the University of Ontario Institute of Technology and upgraded their Oshawa-based technology centre.

Ford has pledged a billion dollars in upgrades to its Oakville facilities, converting its Freestar plant into a "Flexible Manufacturing" facility. DaimlerChrysler has recently announced it will pump $800M into a new Windsor-based paint shop. Over one hundred overseas parts suppliers have settled in Canada, and over a billion dollars in intellectual capital has flowed into Canada in the same period of time.

Given all these positive indicators, the data also telegraph some negative signals. Our parts sector, for instance, is not investing in Canada to the same degree as the assembly sector. Whereas Canadian assembly investment is consistently above 20 percent of the North American total (routinely topping 25%), the parts sector attracts less than 10 percent of the continent's new parts-related capital expenditures. This is a big deficit, and it shows that there is still a great deal of room left in our industry for positive growth.

Still, Canada is in an excellent position. We buy roughly eight percent of the North American vehicle fleet, but we account for between 15 and 18 percent of yearly manufacturing investment. We are strong. We have more

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money being invested for intellectual capital development, more money for new construction, and more money for facility improvements and repair. There is no crisis here.

In sum: solid capital expenditure bodes well for future production. No crisis.

Ground Rules for Success

Although our industry is not in crisis, there are some serious concerns percolating through the analytical community. In order to ensure the continued prosperity of the Canadian Automotive Industry, some ground rules should be understood and respected:

- Protectionism is deadly. Contrary to the CAW's position, free trade agreements have helped - not hurt - Canadian suppliers and OEMs. Canada has benefited greatly from free trade with the U.S. and Mexico. Proceed with caution but be open to new ideas.

- Decision makers should keep their blinders on when considering the nationality of prospective investors. Be neutral. There are no good guys or bad guys, incumbents or interlopers. Any automotive manufacturing operation - be it from the U.S., Japan, Korea, or Poland - is a good guy whose business should be encouraged.

- It is impossible at this point to predict winners and losers, so don't try. Create a supportive economic climate for everyone.

- Government has a legitimate and beneficial role to play. As mentioned above, there will be blood on the floor as certain crisis-plagued OEMs shed excess labour and infrastructure. Governments can help soften the economic blow of such adjustments, acting at both corporate and individual levels. Jobs lost through attrition are likely to make up the bulk of GM's cuts, but there will no doubt be a cohort of unlucky linemen falling victim to the situation. Government has a role to play in this adjustment.

- Corporations can also benefit from government assistance. The more heavily we incentivize greenfield developments and existing infrastructure expansion, the more attractive we are to investors.

- I cannot overstate the importance of trade missions. Whether traveling abroad themselves or attracting foreign delegations here, the successful local and regional planning organizations need to place an emphasis on international investment.

- The Windsor border situation is hopeless. Fortunately, this will not impede Ontario's auto sector growth opportunities because of a fundamental realignment that has taken place over the past two decades. If you plot the locations of all the parts and assembly installations that have appeared after 1985, you will find that the majority of them form an East-West axis through mid-Ontario, bisecting Sarnia, London, and Fort Erie. This runs counter to the traditional North-South, Windsor-to-Oshawa axis. With the flow of goods running through modern, politically accommodating border crossings at Sarnia and the Niagara Peninsula, manufacturers no longer have to adjust to Windsor's provincial infighting.

- How ready are we for global competition? China and India are, at present, over hyped. They are indeed growing quickly, but Chinese components currently comprise only 1.1 percent of the North American parts market. It will be years before Chinese produced vehicles represent a credible threat to our industry. Watch them carefully, but also remember that our industry has plenty of room to grow under the influence of existing players in the market.

As far as the restructurings at GM and Ford are concerned, it's difficult to argue with logic. The basic North American vehicle production paradigm has been nurtured to an unhealthy level, so major surgery is a necessary step to maintaining international fitness. This restructuring will result in 'profitable prosperity' - exactly what our industry needs. The Canadian automotive sector is NOT in crisis; it is actually in pretty good shape. DAR

Have a happy and healthy new year.

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