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OBSERVATIONS

Dennis DesRosiers

The Cerberus-Chrysler Deal

I have never dedicated an Observation to a single OEM. I've traditionally been of the view that pointed criticisms will provoke an unpleasant defensive response, and I generally don't need the hassle. If I go out of my way to complement any specific automaker, their competitors will come out swinging and I would rather avoid that hassle as well. Therefore, being in a lose-lose situation, I always sidestepped the issue.

I would be remiss, however, to avoid commenting on the just-announced Cerberus-Chrysler deal, where by a private equity firm has purchased a large controlling share of the Chrysler Group from Daimler. This is a very interesting and important story, and I thought I would provide my readers with some insights.

I still haven't gotten final details of the deal, but here are what I understand to be the key elements:

- Cerberus pays $7.4 billion for an 80.1 percent share of Chrysler (all figures in US dollars).
- Daimler keeps a 19.9 percent equity stake of Chrysler.
- Pension and health care liabilities stay with Chrysler, leaving Daimler essentially free from that burden.

The structure of the deal is fascinating. Cerberus pays $6.1 billion of the purchase price directly into Chrysler and the remainder ($1.35 billion) goes directly to Daimler. On the surface, it looks like Daimler only receives about $1.4 billion for their 80.1 percent equity stake in Chrysler. However, Daimler also is going to invest about $1.7 billion into Chrysler and will lay out hundreds of millions in closing costs and other fees. In effect, Daimler is paying an estimated $650 million for the privilege of offloading Chrysler. They originally paid $36 billion, so the Daimler purchase of Chrysler in 1998 goes down as one of the largest destroyers of capital in the history of capitalism. Simply amazing! Also, remember that Daimler is still on the hook for 19.9 percent of the health care and pension shortfall estimated to be in the $18 billion range, so who knows where this all ends up from a dollars-and-cents perspective.

I believe that this was the best deal for Daimler and they made the correct decision to sell to Cerberus. Chrysler is a very valuable brand that needs two things to succeed: deep pockets to fund product programs and ruthless private equity to cut costs and bring it back to its glory. Cerberus was in a unique position among Chrysler's suitors to accomplish those goals, and they are now poised to execute those plans. Awash with cash like many other private equity firms, they are certainly have deep pockets, and they also have a proven record of taking undervalued assets and doing whatever it takes to turn them into profitable organizations. Cerberus will immediately seek to cut wage and benefit costs by up to 30 percent and the unions will have little say as this goes forward. In an effort

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to unlock some of the company's value, they will also sell just about every asset in Chrysler's portfolio that is not performing to their strict criteria. Future investments will not play favourites with any existing jurisdiction, since Cerberus' investment decisions are governed by profit, not political correctness.

Chrysler is a valuable brand for a number of reasons. They are one of the oldest OEMs in North America with a storied history of quality engineering. They have a well-established dealer body - a major benefit to any organization since efficient distribution is becoming more and more valuable in this industry. For example, the Chinese are itching to enter into North America to take advantage of their low cost domestic manufacturing, but they are hamstrung by their lack of a distribution system. Chrysler is already rumoured to have a deal in place with Chinese automaker Chery to distribute a Chinese-made small car.

Chrysler has 12 platforms of their own, some of which have been renewed in recent years or are in the process of renewal (e.g. minivan) so they are not that far down the product development curve. Now, we do believe that there is still quite a bit of work to be done on the product lineup - much moreso than Chrysler would have you believe - but they are in relatively good shape. Over the past decade, they have been fairly successful - especially when compared with Ford and GM - in keeping their volume vehicles slightly fresher than the Detroit average. One can question whether those platforms - regardless of their age or technical competitiveness - are in-line with current market tastes, but there is no denying that Chrysler's platform age graph shows markedly less reliance on outdated vehicles.

A look at Chrysler sales indicates that they are actually holding up fairly well in the face of stiff competition from the overseas nameplates. I pulled together the following table (see Chart 1) which tracks their sales performance in Canada and the U.S. over the last 25 years. From a low market share position of just 11.2 percent in 1981, they grew their share to a peak of 16.4 percent in 1996, two years before they sold to Daimler. Sales volumes grew from a low of 1.3 million in 1981 to a peak of 2.9 million in 1999. Much of this can be explained by the concurrent market explosion during this period, but Chrysler did pick up share.

The current decade has not been as kind. Chrysler's Canada-U.S. market share dropped to 13.0 percent last year on sales of 2.4 million units. If there's a silver lining in this bad news, it's that Ford and GM saw their market shares and volumes drop more than Chrysler's. The company is clearly sick, but it retains a relative degree of health compared to the other kids on the block.

The sales table also clearly identifies their challenge. Passenger car share is now in the mid single digit range at 6.7 percent - stable, but still on the low side of the equation (especially considering that it represents just half of their car share peak of 12.8 percent in 1985). Of note is the fact that the 6.7 percent share includes the widely successful Chrysler 300 group of products. I can't imagine where they would be without this fundamentally important vehicle. They obviously have a lot of work to do on the passenger car side of the market.

The burgeoning light truck market was their saviour over the last few decades, growing from an 11.8 market share in 1983 to a peak share of 24.7 percent in 1996 with a five-fold increase in volume. Volume was under 300,000 units in 1981 and peaked at over 2 million units in 1999 and 2000.

Chrysler is very much a truck company with over three quarters of their sales going to light trucks for most of this decade. Strength in trucks is also their present vulnerability given high gas prices and the "green" agenda snowballing its way across North America. Chrysler rode light trucks and Hemi engines to high profits and are now caught with the wrong product at the wrong time. Managing the move to more environmentally-friendly products will be the biggest challenge of management.

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I suspect that these product issues are at the root of the $8 billion capital injection jointly supplied by Cerberus and Daimler. This will give them a nice cushion to work with over the short term as product issues are addressed. Indeed, I imagine that Tom Lasorda feels a little bit like a kid in a candy store. The coffers are temporarily filled and he's out from under the shackles of the Daimler management system that supposedly stifled growth and co-operation. No matter how much protest, what we suspected back in 1998 has now been proven true: the DaimlerChrysler partnership was very much not a merger of equals. Much has been written about the culture clash between Germany and Detroit, and I have no new insights to add, but I do believe it was one of the issues for underperformance at Chrysler. It's also important to understand that this clash of cultures won't disappear with the Cerberus deal. Daimler still owns 19.9 percent of Chrysler and they have at least two sharing developments that are well past the point of no return. Chrysler will be working with Mercedes for quite a distance into the future.

As for Magna, I think they are very lucky not to have won. Virtually everyone I talked to inside and outside of the industry thought that the Magna angle made little sense. First, Magna is a big company but they don't have anywhere near the cash reserves needed to make a deal like this work. Second, they have some manufacturing experience with Magna Steyr but the business of running a single group of plants is very different from that of running dozens of plants at once. Third, Magna has huge business with GM and Ford. Yes they would have been able to keep the bulk of their contracts but future business would have been at risk. Fourth, Magna has struggled in a union environment and to cooperate with Chrysler, they would have essentially had to invite the unions into their other operations. Indeed, this rather large Pandora's Box may have already been opened, as Magna got very cozy with Buzz Hargrove and Ron Gettelfinger in the run up to this deal. The over-80,000 non-union Magna workers will be more receptive to signing union cards now that Magna has come out and said they are willing to work with unions as a result of this Chrysler bid. Fifth, I can't imagine Magna having the depth of management talent it would take to run a company the size of Chrysler. GM backed out of the bidding primarily because it would divert too much management talent away from their own turnaround strategy. There are other aspects of this deal that didn't make sense, but suffice to say that Magna is probably quite lucky not to have been successful.

In these deals it is always interesting to speculate who are the winners and losers. As I already mentioned, I believe that by losing this battle, Magna was a winner. Indeed, by standing by their number-one customer and telling the whole world that they would help where necessary, I'm sure that Magna's fortunes inside Chrysler are at an all time high.

Canada and the U.S. Market - Chrysler Summary

	Total Market	Total Chrysler Vehicles	Total Chrysler Share	Chrysler Passenger Car	Passenger Car Market Share	Chrysler Light Truck	Light Truck Market Share	Light Truck Share of Total Chrysler
1981	11,331,549	1,273,440	11.2%	992,639	10.7%	280,801	13.8%	22.1%
1982	11,165,576	1,265,606	11.3%	928,647	10.8%	336,959	13.1%	26.6%
1983	13,090,937	1,565,446	12.0%	1,191,005	12.0%	374,441	11.8%	23.9%
1984	15,519,116	2,182,860	14.1%	1,446,988	12.7%	735,872	17.7%	33.7%
1985	17,028,551	2,491,736	14.6%	1,558,492	12.8%	933,244	19.2%	37.5%
1986	17,620,066	2,508,764	14.2%	1,548,446	12.3%	960,318	18.9%	38.3%
1987	16,417,196	2,254,118	13.7%	1,239,603	10.9%	1,014,515	20.0%	45.0%
1988	17,027,907	2,475,387	14.5%	1,349,954	11.5%	1,125,433	21.1%	45.5%
1989	15,986,165	2,248,370	14.1%	1,159,998	10.7%	1,088,372	21.1%	48.4%
1990	15,186,688	1,893,098	12.5%	969,339	9.5%	923,759	18.6%	48.8%
1991	13,654,281	1,715,511	12.6%	813,282	8.9%	902,229	19.9%	52.6%
1992	14,113,709	1,919,698	13.6%	778,525	8.6%	1,141,173	22.6%	59.4%
1993	15,110,114	2,248,457	14.9%	942,420	10.1%	1,306,037	22.5%	58.1%
1994	16,343,862	2,424,376	14.8%	929,138	9.5%	1,495,238	22.8%	61.7%
1995	15,859,442	2,361,862	14.9%	883,769	9.5%	1,478,093	22.6%	62.6%
1996	16,268,341	2,665,011	16.4%	919,414	10.0%	1,745,597	24.7%	65.5%
1997	16,508,057	2,529,722	15.3%	823,822	9.1%	1,705,900	22.7%	67.4%
1998	16,933,321	2,749,488	16.2%	825,365	9.3%	1,924,123	23.9%	70.0%
1999	18,391,662	2,872,361	15.6%	829,891	8.7%	2,042,470	23.0%	71.1%
2000	18,898,864	2,773,302	14.7%	738,536	7.6%	2,034,766	22.1%	73.4%
2001	18,692,978	2,527,311	13.5%	634,708	6.8%	1,892,603	20.1%	74.9%
2002	18,519,614	2,463,677	13.3%	600,277	6.6%	1,863,400	19.7%	75.6%
2003	18,232,545	2,350,020	12.9%	522,251	6.2%	1,827,769	18.7%	77.8%
2004	18,379,598	2,416,339	13.1%	532,866	6.4%	1,883,473	18.7%	77.9%
2005	18,527,445	2,512,966	13.6%	592,084	7.0%	1,920,882	19.2%	76.4%
2006	18,114,988	2,354,852	13.0%	579,538	6.7%	1,775,314	18.7%	75.4%
2006/2005	-2.2%	-6.3%		-2.1%		-7.6%		

Source:DesRosiers Automotive Consultants Inc., AIAMC, CVMA, and Ward's Automotive Reports

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Now that Chrysler is split from Daimler, they will need an entity like Magna to replace some of the capabilities that Daimler brought to the table through their Mercedes division.

Cerberus is a winner by picking up a significant under-performing asset relatively inexpensively. This is their game and they know how to play it very well. In addition, Cerberus owns 51 percent of GMAC that they picked up from GM last year. Chrysler financial will fit very well into GMAC, and a very quick profit can be turned by rolling these financial assets together and realizing radical cost reductions. The workers at Chrysler Financial may be some of the early losers in this transaction, although a lot of water has to flow under this bridge before we will know anything. However, if I worked in the finance arm, I would be very worried.

The unions - both the CAW and UAW - are big losers. They came out very vocally against private equity, thereby losing any friends that may have existed in the ranks of private equity. Now they likely don't have any friends at Cerberus - a company that, quite frankly, is in this game for a single reason: to make money. Welcome to the real world of market economics! Cerberus will be quite demanding in the union negotiations this fall and the unions will have no choice but to acquiesce. Also, watch Cerberus make tough decisions on plant closures, platform consolidation, model consolidation, and employment in every division (including head office). This will become a lean organization.

On this note I believe that Rick Wagoner is also a big winner. General Motors will be on the coat tails of Cerberus in negotiations demanding the same if not a better deal from the unions. GM will gladly let Cerberus play the bad cop. If, in five to seven years, Chrysler is turned around and once again considered a great and profitable brand, then GM will be at the table and may indeed be more than willing to buy a revitalized Chrysler. Listen to what GM said when they backed out of the bidding: they valued some of the Chrysler brands, but they didn't want the job of fixing them.

Daimler clearly lost in this deal. To move from a $36 billion selling price to having to pay someone to take the company off its hands will go down in the annals of industrial deals as one of the top ten flops in modern business history.

I also suspect that Alan Mulally at Ford is not very happy. He's been forgotten over the last few months as the global media spotlight focused on Chrysler. Now that this deal is done, Ford will be the new target for media hawks. Given the negative valuation of Chrysler, I can't imagine the Ford family being too pleased with the deal. Is this what they could expect if they were to go through the same process? Will Ford have to pay someone to take the company off their hands?

Daily rental companies lost. The new lean and mean Chrysler will be less motivated to sell vehicles to the daily rentals at a loss. Now that GM and Chrysler have backed out of fleet to some degree, it will be interesting to see if Ford or the Japanese step into the fray or whether the daily rental companies will now have to start paying closer to market value for their vehicles.

Other than Chrysler Financial and some leaning out of workers across the organization, Canada would appear to be safe. The two assembly plants in Windsor and Bramalea are rock solid and unlikely to be threatened. Chrysler also has their advanced engineering centre (ARDC) in Windsor and it would appear to be even more necessary today as Chrysler has lost some of the technological capabilities that Mercedes brought to the table.

Finally, the senior management team at Chrysler must be thrilled and at the same time frightened at what's in store for them. Thrilled because they can now do all the things they wanted to do but without the difficult cultural constraints of working with Germany. Frightened since this is a big, big job. DAR

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