Toyota rattles the auto market

The phenomenal performance of the Japanese company Toyota is a challenge to competitors in the US and Europe. Its success story is built on a strategy of continual improvement

Toyota cars, with their stylized T on the radiator grill, are still not that common a sight on the streets of Europe, but globally the company is in the driving seat. The Nagoya-based group overtook Ford last year and is currently the world number two behind General Motors, selling around seven million vehicles a year. Toyota has long been the number one on the stock market; in fact, its market value at mid-May was greater than that of GM, Ford, DaimlerChrysler and BMW combined. This is due in large part to the company's extremely healthy balance sheet, as also reflected in its triple-A bond ratings. Despite the size it has already attained, Toyota continues to grow much faster than average. In the financial year ending March 2005, it sold 10% more vehicles than it did during the previous 12 months.

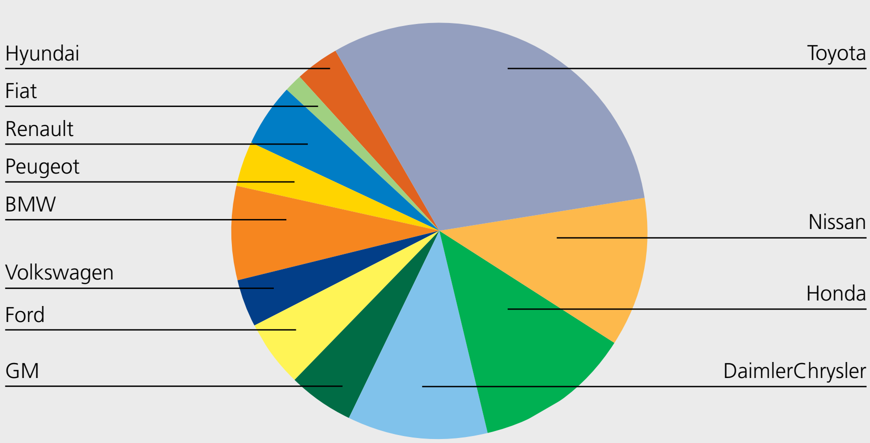
Markets in the world's industrialized nations reached saturation point long ago. Japan, Europe and the US are only growing by around 1% annually. However, with the exception of its domestic market, where Toyota is already dominant with a share of over 40%, Toyota is steadily gaining market share worldwide. It has rivalled domestic manufacturers in the US for decades, and is opening up new production capacity in eastern Europe, China and elsewhere in Asia.

You could fill an entire library with the things that have been written trying to explain Toyota's success, its secret formula. The answer likely is found in one word that crops up time and again: *kaizen*. This is a Japanese term that can be translated as 'perpetual improvement'. *Kaizen* covers all factors that play a part in a company's success. Toyota's commitment to this concept has for decades been second to none, with the result that Toyota is quite rightly regarded as the biggest achiever in the entire global automotive industry.

Honda's clever steering

Only one other Japanese carmaker has successfully faced up to Toyota. Honda was savvy enough to quickly get out of Toyota's way and it now manufactures and sells more vehicles in the US than in the rest of the world, including Japan. Honda moved into China at an early stage and now sells about three million cars and 10 million motorbikes a year there. All the other Japanese players have surrendered their independence. Ford owns a sizeable chunk of Mazda, while General Motors is a major shareholder at Subaru and Suzuki. The Mitsubishi Motors management team is looking to go it alone again following an ill-fated liaison with DaimlerChrysler, but is recording hefty losses. Nissan would have gone under at the end of the 1990s without a financial injection from Renault. The French company today holds 44% of its stock. The remaining players from around the world don't have much time left to learn how to cope with the might of the automobile dynamo from Nagoya.

Market capitalization (May 2005)



The market capitalization of the big carmakers reflects their profitability. The very strong fundamentals at Toyota, Nissan and Honda would merit even higher valuations for these companies. But given the medium- to long-term prospects for the country's big three carmakers, we think their current share prices are about right. Renault's stake in Nissan is not yet sufficiently factored into the Renault share price.

There are three options at the basis of successful competition: to produce goods more cheaply than competitors, to sell products for a higher price than competitors or to combine both of these strategies. The carmaking process is constantly refined, and suppliers – whose significance is growing – are being incorporated into it more and more. No other manufacturer has mastered this optimization process as perfectly as Toyota. Here, we see *kaizen* in action.

Size is a key advantage in bringing down production costs, e.g. in purchasing. The effect is soon felt when an alliance is entered into, as Renault and Nissan found out. Being able to spread fixed development costs across a greater number of units also helps lower costs. These days, engines, gearboxes and other car components are often identical across a manufacturer's entire range of models. The Renault Modus, for instance, is the first model with the same chassis as the Nissan Micra, while the new Clio and Twingo will be 'half-Japanese'.

Apart from Toyota, Hyundai is the only other manufacturer that seems to have successfully trodden the cost-cutting route. The Korean carmaker continues to offer consumers good value for money, while it has also massively improved quality over recent years. Its unit sales and record profits illustrate just how successful the company has been with this strategy. The rest of the industry needs to act quickly, Toyota already has the lead.

Successful luxury models

Under these circumstances, the option of constructing high-quality, expensive cars with a price tag reflecting their higher production costs looks the more promising route. But the case of Audi shows how long it can take to position a brand in this segment. Audi's cars still fetch less than BMWs or Mercedes.

By contrast, Toyota launched the Lexus luxury brand in the US 15 years ago and enjoyed instant success. US Lexus sales have been outstripping those of Mercedes, BMW or Cadillac for years now. The models from Japan may have appeared rather conservative at first, but the new generation of cars from the design studios of California and Nice create quite a different impression. Once again, we see an instance of *kaizen* in practice.

So far, the company's success in the luxury segment has been confined to the US. The new Lexus models with improved diesel engines and ground-breaking hybrid technology will show whether Mercedes and others will be able to hang onto their positions in Europe. The Toyota Prius has already been named European Car of the Year 2005. /

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Prospects for automotive bonds

The downgrades of GM and Ford bonds (the big two) at the start of May sent shockwaves through the automotive bond market. Investors considering buying bonds of these two carmakers first need to be certain about their **risk tolerance.** Anyone not prepared to invest in speculative, high-risk bonds should avoid GM and Ford. Those who are prepared to take on the high risk should favour short-term paper, as the time to maturity is a key factor in the risk associated with bonds.

Like the rating agencies, we at UBS see **no immediate liquidity crunch** that might affect the repayment of short-dated bonds (expiring 2005–2007). The big two still have plenty of liquidity and can also obtain funds from other sources than the traditional bond market.

The considerably greater risk harboured by **longer-dated bonds** must not be neglected. The problems at GM and Ford are deep-seated and are not about to solve themselves. Detroit's car manufacturers are constantly losing ground to Asian rivals. Their market position in passenger cars is weak, and sales of highly profitable four-wheel drive vehicles and pick-up trucks are being depressed by the high price of oil. Hefty healthcare and pension costs for employees and pensioners will also burden the companies' balance sheets for years to come. Last year, GM had to price-in around $1,500 in medical bills, hospital treatment and drugs for each car it sold.

GM and Ford are yet to come up with convincing plans for resolving their structural difficulties.

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