The Ruggles Report™

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Drop Dead Day

Well, we were ready to go to "press" with a piece on the wholesale market and auctions, when "Drop Dead" day for GM and Chrysler arrived and Rick Wagoner's head rolled. I have been shocked by the "hue and cry" from so many different angles. So the piece on wholesale will have to wait.

The Ruggles' Report is an ongoing, independently published report with insights, reflections and opinions from noted vehicle expert David Ruggles.

As you are probably aware, the Bush Administration "bridged" GM and Chrysler with TARP funds on December 12, 2008. The plan was to tide the manufacturers over and let the next administration deal with the true "nuts and bolts" of a long term plan.

$17.4 billion was advanced to Chrysler and GM in secured loans. Chrysler got $4 billion up front while GM was slated to receive the rest in increments. The loans were made due December 29, 2011 and had important conditions attached.

The first critical condition was that GM restructure its labor costs to achieve parity with S. Detroit manufacturers, who are union free. While agreeing at the time to get the December TARP loan, UAW President Ron Gettelfinger reportedly stated that he would seek removal of this stipulation from the Obama administration.

The second key condition was that GM reduce its debt by two thirds through a stock for debt swap with bondholders. It was stipulated that on February 17, 2009, GM must submit a signed term sheet to the Presidential designee to show compliance with these terms.

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On March 31, 2009 a report was due from GM showing compliance with the terms or why any deviation should be justified. In addition, a complete business plan was to be submitted for review by the Presidential designee. Should the Presidential designee believe that GM does not have plans in place to become viable, the loans became due almost immediately, which would have forced GM into immediate bankruptcy. Hence, the term "Drop Dead Day."

As we learned yesterday, the terms were not met and the business plan was deeply flawed. The Administration had choices. They could have:

1. Accepted the plan, flawed as it was, and continued to bridge GM indefinitely so the UAW and the bondholders could extend their denial of reality. This would have been a politically popular move with organized labor AND with the bondholder, an assortment of Wall Street types. The Administration could have betrayed the taxpayers while pleasing two disparate political groups.
2. Called the original loans and forced GM into bankruptcy which would have disastrous implications on our entire economy.
3. Done something else.

The Administration chose #3. They granted an extension, and changed GM's CEO.

There have been many polls showing auto industry people in favor of Wagoner's "forced resignation" at the rate of 70%. Some agree with the "forced resignation" but disagree that the Administration should have the power and authority to influence such a decision within a "sovereign" company. This despite the fact the taxpayers own the most senior debt of GM and have been given the authority as a condition for receiving the money in the first place.

Others dismissively want the car companies ushered into bankruptcy court as if that's an easy thing to do. Those who view bankruptcy as the best option may be correct, and it may come to that. But first a quick review of a recent bankruptcy to provide some perspective.

The Impact of Corporate Chapter 11 Bankruptcy

United Airlines declared Chapter 11 in 2002 and emerged in 2006. An airline and an auto company are two quite different business entities. A comparison of an auto manufacturer and an airline should note the fact that the auto manufacturer depends on a long string of supplier manufacturers. In today's economic climate, those supplier manufacturers are on thin ice. A Chapter 11 filing by GM would most certainly be followed by Chapter 11 filings and liquidations of an entire string of suppliers.

The Pension Benefit Guaranty Corporation was 23 billion dollars in deficit BEFORE UAL dumped a $9.8 billion default on them. As a practical matter, the "cost" to the government was “only” about $6.6 billion. Many UAL workers in retirement experienced a 50% cut in pension benefits. But let’s focus on the $6.6 billion cost to the PBGC and try to put this in GM terms.

First, a little background: According to a New York Times article in July of 2008, GM’s maintenance of a corporate welfare state became too obvious to ignore. From 1993 – 2007 it spent $103 billion on legacy pensions AND retiree healthcare. What else could it have done with the money had it not obligated itself to “legacy” costs? In the 1990’s, GM could have designed new vehicles OR even acquired half of Toyota. It did pay $13 billion in dividends but GM has always existed more for its retirees than for its owners.

A GM bankruptcy, either via Chapter 11 or Chapter 7, would create a pension liability of roughly $23 billion dollars. This is IF there are no supplier bankruptcies added to GM’s. This is IF Chrysler and Ford can avoid bankruptcy as well. Imagine all three in Chapter 11 along with a large number of their suppliers.

The Government’s Role In This

But now GM has a NEW stakeholder. The taxpayers have loaned GM MORE than its current book value, and by a large amount. There were written and agreed to “strings” attached to these loans. It takes political guts for the Obama administration to take a stand that runs counter to the wishes and desires of one of its core constituencies, the UAW. This at the same time the unions’ “Card Check” initiative is foundering and the administration isn’t going out of its way to try to resuscitate it. Yet, some of the current conversation has to do with the audacity that the major stakeholder should have any influence in a company that owes its very existence to that stakeholder.

So why not a Pre-Packaged Bankruptcy (PPB)? A PPB is a plan for financial reorganization that a company prepares in cooperation with its creditors that will take effect once the company enters bankruptcy. This plan must be voted on by shareholders before the company files its petition for bankruptcy, and can result in shorter turnaround times and less cost.

Given the fact that the Administration seems to want the power to trump decades of franchise dealer law in the 50 states, something I strongly disagree with, I don’t see enough critical parties agreeing to a PPB for it to work.

Yet the most obvious reason to avoid PPB is because of uncertainty. It's never been done before with a corporate entity as large and complex as GM. The chain reaction through the supplier base is also unpredictable. It could even drag Ford down at the same time. Competing with a rival under bankruptcy protection is difficult enough when times are relatively good.

In more certain times, "Debtor in Possession" financing could be obtained through normal channels. In today's economic and banking climate, the government is the only option to provide this financing.

Let's review some auto industry suppliers' names:

- Delphi, just sold its brake business to China
- Johnson Controls
- Arvin Mentor
- Goodyear Tire and Rubber
- Tenneco
- TRW
- Visteon, just declared its UK plants insolvent
- Lear
- Federal Mogul
- Hayes Lemmerz
- Borg Warner
- American Axle

These are only a few - and they are not your local Checker Auto Parts stores. Instead, we are looking at HUGE global companies with tens of thousands of employees, R&D departments, hundreds of millions in sales, and LEGACY COSTS to be dumped on the taxpayers. These companies also have hundreds, if not thousands, of companies who supply them. Some of these companies are deeply involved in aerospace and other critical industries. It is just impossible to predict the consequences of the potential ripple effects throughout industry and the world economy.

This piece is not designed to be a scholarly accounting of all the costs that might fall on the U.S. taxpayer in the event of a Chapter 11 filing. I'll leave that to economists. The intention here is to give a general idea of how expensive and unpredictable a GM Chapter 11 might be for taxpayers.

In Chapter 11, the media scrutinizes everything. Imagine the "hue and cry" when it is discovered that the BK judge approved hundreds of millions of dollars in attorney fees and granted RETENTION BONUSES to keep critical executives. All of this is why the most knowledgeable people associated with the auto industry understand that there is less risk and less taxpayer exposure with a "bailout" than with a pre-packaged bankruptcy. But GM's "PLAN" has to make sense.

In the absence of Chapter 11 and without government (taxpayer) "Debtor in Possession" financing, the only other option is liquidation. There is NO EVIDENCE that DIP financing could be made available in today's economic climate from the usual private sources.

So what would happen under liquidation? I disagree strongly with an economist on CNN last night who stated the auto industry represents 2.8 percent of the total economy and to lose that would be catastrophic.

He failed to acknowledge the fact that sales would be picked up by other manufacturers' dealers, after a period of intense confusion. BUT chain reaction effects are sometimes hard to predict. I'm not sure our economy needs any more uncertainty than it has. I can imagine the government trying to honor a liquidated auto maker's product warranties without dealers, technicians, and repair parts.

The Shortcomings of the GM Plan

Following are the basic criticisms of GM's survival plan by the auto industry task force and some commentary:

According to Automotive News, the Obama Administration Auto Task Force has 5 distinct complaints with GM's survival and success plan under the following headings:

1. Market Share Projections
2. Price/Profit Margin
3. Brands/Dealers
4. Product Mix
5. Legacy Liabilities

1. Market Share: GM's projections were overly optimistic, and by a large margin. At the same time GM stated it would reduce fleet sales, dealers, and entire brands, its market share projection only reflected a market share drop from 21.5% to 19.1% by 2014. They are set to get rid of Hummer, Saab, Saturn, most of Pontiac, plus 2,000 dealers and they only project their market share to drop by 2.4 percent? I wonder why the Administration didn't go for that?

2. Price: GM's pricing and per vehicle profit projections were wildly optimistic. GM's assumptions were that the incentives required to move vehicles would decline, leaving them with higher margins. The administration did not go for this one either.

3. Brands/Dealers: "GM is currently burdened with under performing brands, nameplates and an excess of dealers," the task force said. GM said it plans to offer just four core brands -- Chevrolet, Cadillac, Buick and GMC --and a cut-down version of Pontiac. It also said it would reduce its dealer count from 6,246 in 2008 to 4,100 in 2014. The task force said those measures are not aggressive enough."

I'm OK with the part about under performing brands and nameplates. I just don't understand the part about too many dealers. (See last month's Ruggles Report) This is where I have a MAJOR BREAK with the Administration! When they reduce the number of dealers, GM absolutely gives up sales AND market share, which relates back to the first issue of optimistic market share projections. I understand that it's not all about market share if you have to lose money on each unit of sales to achieve that share. But the only way they could shed dealers would be through Chapter 11, and that would drag on for YEARS! And it would be totally counter productive.

4. Product Mix: According to the Administration, GM is still too dependent on Trucks and SUVs. The VOLT will carry a $40,000. price tag. After the "Greenies" and the "Be the First on the Block" crowds, who will pay this kind of technology premium in the face of $2.00 fuel? "Where are the fuel efficient products for consumers to buy today?" asks the Administration. GM has them, but until they rein in their cost structure, they aren't profitable enough to sustain the company in the current economic climate.

5. Legacy Liabilities: If you have read this far, you have already encountered our commentary on pension funds and how a bankruptcy would inject some very negative "knowns" and "unknowns" into the equation.

"To reach its pension obligations without substantial changes would require GM to sell 900,000 vehicles per year just to cover these obligations," according to the task force. That would leave GM in the familiar position of being a company that exists for its retirees, rather than for its owners. "That would leave GM fighting to maximize volume rather than return on investment," the task force said.

Because of the action of the Administration, I hope the bondholders AND unions will be forced to take stock in lieu of other obligations, rather than GM seeking Chapter 11! It is better than what they would receive in either form of bankruptcy.

And there is considerable upside to it! Trading stock for debt will address 4 of the 5 major issues the Administration has with the rejected GM plan. If GM's cost per vehicle is much lower, they can use more realistic and conservative market share projections. They wouldn't be so vulnerable to the financial impact of the aggressive incentives that might be required to move iron in a weak economy.

Also, it would free up capital for investment in new products. GM's survival and success would be less dependent on people paying a technology premium for vehicles like VOLT and their new HYBRID products.

BUT through it all, I'm still stuck on this idea of getting rid of 2,000 Dealers.

Learning From History

I lived through the Chrysler bailout of the Carter years. Shortly after his inauguration Reagan didn't endear himself to Lee Iacocca when he made the comment, "You're lucky I wasn't in office when you came for money or you wouldn't be here today!" It was with great pleasure that Chrysler and Iacocca paid off their loan guaranties early and with proper interest. No one expected this to happen so Chrysler had neglected to negotiate a pre-payment interest credit. It was so important for Lee and the boys to "stick it" to Reagan and pay the loans off early! These are different times but there are some similar circumstances.

In the eighties, Chrysler had to liquidate its private planes and tolerate a high level of scrutiny. The deal was loan guarantees, and Chrysler had to deal with a multitude of banks. Every "I" and "T" had to be dotted and crossed.

Chrysler was floating on its dealers and we all knew it. We'd talk to the factory guys about it. They'd ask us not to complain to the Feds and maybe the Feds wouldn't notice.

Events were on the news every night. Without the media fragmentation that exists today everyone who was watching TV, or reading the papers, was seeing the same thing.

At the same time we had double digit inflation AND 20 percent floor planning combined with NO sales. Today we have CHEAP interest and virtually zero inflation. I had 3 floor plan banks in 20 months without having to resort to Chrysler Credit, which was "limited repurchase" at the time. We were fortunate to have been so profitable at the time that banks would even talk to us.

I was interviewed on national TV every month for over a year. They'd come to the Dealership in Evanston Illinois, an immediate Chicago suburb, with the complete camera crew to do the deal.

During this time, all Dealers' books were bogus to a degree. Our receivables were overstated. No one would have paid "book value" for them. Warranty, holdback, and incentive receivables from Chrysler? Are you kidding? Mark to market? We would all have been "dead meat."

In addition, facilities weren't worth what was owed on them. Most facilities were actually owned by ABKO Properties, a joint venture between entrepreneur George Ablah and Wichita-based Koch Industries formed specifically to purchase Chrysler Realty Corporation in the late 1970s. They purchased these facilities from a hard-pressed Iacocca and as such, fixed assets were overstated based on the current market conditions.

It was a huge house of cards that managed to stay intact, largely because of the personality and leadership of one man! His ability to bullshit and obfuscate should not be underestimated. He could look you in the eye and lie to you... you knew he was lying... he knew that you knew he was lying. You knew that he knew that you knew he was lying.... he made you not care and do what he wanted anyway.

At some point, people bought Chryslers in support of American business and in support of the "underdog." They were such lousy vehicles in those days. The warranty costs on them were terrible, BUT the dealers got paid for fixing them, eventually. Many consumers just looked the other way.

There were a lot of behind the scenes activities to urge municipalities and states to buy Chrysler squad cars. Pressure was put on fleet buyers to buy Chrysler products. Some pressure came from bankers who had skin in the game. Some came from the Government behind the scenes.

The K car provided cover for Chrysler to buy time, in hopes of the loan guarantees AND a return of the market. Chrysler had been highly criticized for depending on "gas guzzlers." When the first K cars were shipped to dealers, they had only built fully loaded ones in their search for gross profit dollars.

The cars were terrible. The engines were rough and dashboards rattled and buzzed. The steering wheel would put your hands to sleep from the vibration. The MSRP was over 10K, and this was in 1980 for a 4 cylinder car.

In my view, the money made on each K car in the beginning wasn't enough to make much headway. The real monetary progress came when the public started buying redone Volares called New Yorker Fifth Avenues, Cordobas, Furies, Dodge Trucks, etc. Iacocca had parlayed the prospect of the K car into enough time to bridge the company to a return to the market that existed before the fuel price spike that set the whole thing off in the first place.

In time, the K car evolved into some decent machinery including LeBarons, minivans, etc. Chrysler made enough money to buy Jeep, and the rest is history.

The pressure exerted by the government as a condition for the loan guarantees enabled Chrysler to exact concessions from stakeholders to reduce their costs.

Today, GM's offerings are much higher quality compared to the rest of the market than Chrysler's were in the 80's. If it were only GM down 40% in the market, we could draw different conclusions.

Wrapping It All Up

It's still possible for GM to reach major concessions with the UAW and bondholders, dramatically reducing their costs. At the same time, the market could return for SUVs and Trucks if fuel stays cheap for a while. Each of these would give GM a real cash injection but their turn-around plan cannot count on it.

In the final analysis, Chapter 11 continues to loom around the corner for GM! Fritz Henderson is the right man for the job as he has extensive and proven global experience. He turned around GM Europe but his most important asset may be that he is NOT a product of the infamous GM U.S. culture.

Regardless, his task is tall and you can bet he'll be watched closely. Because for better or worse, it's the new primary stakeholder that is now calling the shots!

About Dave Ruggles

Dave Ruggles is a widely known, auto industry veteran with more than three decades' worth of experience. His self-titled Ruggles Report is a highly acclaimed industry insider brief detailing the latest hot-button topics in automotive sales, training, recruiting, finance and service.

Ruggles has sold cars, managed, owned and trained dealerships literally across the world. For the last sixteen years, he has spent a month each summer teaching sales desk training to the world's largest privately owned Toyota dealership group in Nagano, Japan.

He lives in Las Vegas, Nevada.

About CyberCalc.com

Based in Dallas, Texas and currently celebrating its 10th anniversary, CyberCalc provides a myriad of software services for the automotive finance industry. The company's namesake product is an internet-based lease comparison system used by franchised dealers, credit unions and independent leasing companies. Additional products include private-label derivitaves and custom designed commercial leasing, workflow and merchant services applications.

The company's latest effort is focused on a soon-to-be-released entry into the Consumer Market: BuyerBidsOnline.com. BuyerBids is set to revolutionize today's new and used car market by providing dealers with only the most serious buying leads. Whether you are a Buyer or a Dealer, BuyerBids will work for you to create an unequaled online car buying & selling experience.