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UNCERTAINTY SURROUNDING GM AND CHRYSLER

Frequently Asked Questions

The auto industry has been a focal point in the media lately, with two of the Detroit Three automakers on the brink of bankruptcy. Both GM and Chrysler are currently being kept afloat on emergency government loans, and must come up with a viability plan in order to sidestep bankruptcy. March 31st was the initial deadline for these automakers to come up with a solid plan. However, both of the plans proposed were rejected by the Obama administration, and subsequently, the Harper administration. The governments have given Chrysler until the end of April to come up with a better plan, while GM has until the end of May before the bankruptcy option is the only one left. The following piece sheds some light on some of the common questions that have been raised regarding the auto industry.

What is the likelihood that GM and Chrysler seek bankruptcy protection?

The risk of bankruptcy for these automakers is quite high – at least 75% – and rising. Negotiations are currently taking place between the U.S. government, the companies and the various stakeholders, but these talks appear to be stuck at an impasse. What is crystal clear is that all stakeholders, including bondholders and the unions, are going to have to make some major concessions whether the automakers file for bankruptcy or not. However, GM and Chrysler are two very different companies, and must be considered separately.

In the case of GM, the Obama administration has clearly stated that a prepackaged bankruptcy would be the best option. Former GM CEO Rick Wagoner opposed bankruptcy protection, but has since been ousted. However, the new GM CEO, Fritz Henderson, has indicated that while not the preferred route, bankruptcy is certainly a distinct possibility – one which the company is intensely preparing for.

For Chrysler, the government has deemed the automaker not viable as a single entity. As such, bankruptcy is almost certain if a partnership with Fiat (or another suitable partner) is not reached by the end of April. And the probability of this deal taking place is now only 50-50 given that Fiat has indicated that it will walk if the UAW and CAW do not match labour costs at the foreign transplants. But even if a partnership is formed, Chrysler must still provide a realistic plan for viability and show its ability to repay the loan in order to secure further aid from the government and stay out of bankruptcy. It is important to note that even if conditions are satisfied for further government funding in the near term, bankruptcy remains a significant risk for both automakers in the future if plans are not executed successfully and/or sales continue to dwindle.

What is a "pre-packaged" bankruptcy?

A prepackaged bankruptcy is when a company enters bankruptcy with a restructuring plan already drawn out and agreed upon by creditors and shareholders. If possible, it is preferred over a straight Chapter 11 bankruptcy – in which the restructuring plan is created once the company has already entered bankruptcy – because it helps the company emerge from protection sooner, saving legal and accounting fees. A prepackaged bankruptcy may be difficult for GM and Chrysler to carry out, given their size, the varying interests of the stakeholders and that negotiations with stakeholders don't appear to be moving quickly enough.

Would the Canadian operations automatically be included in a cross-border filing?

The Canadian operations are separate entities, so any bankruptcy filing in Canada would be separate from the U.S. filing. However, they are wholly owned by the respective parent companies. The Canadian equivalent of Chapter 11 is the Companies' Creditors Arrangement Act (CCAA). Given that the Canadian government has moved in lockstep with the U.S. government, a bankruptcy filing in the U.S. will likely result in the same thing here.

Does bankruptcy mean these companies would cease to exist?

There seems to be a common misperception that bankruptcy would shut these companies down completely. However, the clear answer to the above question is no. Depending on the type of bankruptcy (for example, Chapter 11) a company can still continue to operate so long as they have secured a source of financing – which in this case would be the government. As well, under a Chapter 11 filing, the stock continues to trade. Hence, a bankruptcy filing by one or both of these automakers doesn't necessarily mean that the automakers will cease to exist.

Currently, GM is preparing a bankruptcy plan, whereby the automaker would sell its 'good' assets and brands (such as Chevrolet and Cadillac) to a new company funded by the government, while the 'bad' assets and brands – including health care costs – remain under the old company in bankruptcy protection. Profits from the sales of the 'good' assets would be transferred to the old company to help reconcile claims. This would allow GM to continue its operations, at least of the 'good' brands, while the creditors will be engaged in negotiations.

Under a Chapter 11 filing, Chrysler would similarly still be able to operate. But if the automaker is not able to secure a partnership, a Chapter 7 filing would be the most probable outcome, whereby the company would be forced to liquidate its assets. Under this scenario, the company would eventually cease to exist. However, desirable brands, such has Jeep, would likely be bought by some other company and would likely remain in operation.

As already noted, given the size and complexity of these companies, it could take quite a while – perhaps 1-2 years – before the automakers would be able to fully emerge from bankruptcy. In the meantime, several problems could arise that would hinder output, including possible labour strikes or lower availability of parts, as some suppliers are also facing severe headwinds. However, the government will work with all parties involved to prevent these problems from arising. Indeed, both governments recently agreed to provide aid to parts makers and to guarantee warranties, which will help to lessen the risk that consumers will abandon the companies altogether.

What can the companies achieve in bankruptcy that they couldn't otherwise?

Under bankruptcy protection, the U.S. automakers would be able to break contracts with dealers and unions (including benefits) and write off debt to creditors. They would also be able to get rid of undesirable brands and underperforming factories by dissolving contracts with related parties (i.e., dealers and suppliers of these brands and landlords of leased buildings). Depending on what is negotiated beforehand, the automakers may not be able to rid themselves of all the 'bad debt'. In Canada, while bankruptcy protection would not terminate the labour contracts, at the request of the automakers, the unions could be forced back to the bargaining table. The bottom line is that in both countries, bankruptcy protection would allow the automakers to obtain meaningful concessions from all parties involved, as they would be able to take advantage of laws provided under bankruptcy protection to renegotiate more favourable contracts.

There has been some concern that bankruptcy would cost the government more than the loans requested by each auto maker. GM has now asked for US$30 billion, but has estimated bankruptcy costs of US$40-100 billion, in three different scenarios. Similarly, Chrysler has requested US$9 billion in loans, but estimates bankruptcy costs in the US$20-25 billion range. The high costs are due to legal and accounting fees, as well as other costs associated with the restructuring process. However, without an abrupt turnaround in the sales market, it remains uncertain how much more government aid the automakers will need to maintain operations under the status quo. Hence, the current combined US$39 billion could grow quite rapidly if economic conditions fail to improve. Moreover, for reasons mentioned above, bankruptcy protection will allow the automakers to emerge as much smaller, yet more stable entities – which will hopefully prevent the need for future government loans.

What is Obama looking for when he says GM's and Chrysler's restructuring plans aren't good enough? What are the key obstacles to competiveness?

The viability plans that were rejected by the government did show some improvements. GM's plan included a net debt reduction of $18 billion (from $28 billion), a narrowing of the gap between labour costs with the foreign transplants, a breakeven sales level lowered by 1 million units, and a positive cash flow by 2012. Similarly, Chrysler's plan included cutting dealer margins, $5 billion reduction in outstanding debt, and conditional Voluntary Employee Beneficiary Association (VEBA) modifications.

The Obama administration stated that these improvements were not enough to return the automakers to viability. However, the government remains in talks with the automakers in order to clarify what exactly it expects the improved viability plans to look like. The government is looking for deeper concessions from all parties involved, a further reduction in debt, full competitiveness with foreign transplants (both labour costs and reworking the funding of the healthcare trust for retirees), more realistic sales forecasts, and in the case of Chrysler a partnership, in order to grant further loans to the automakers. The U.S. government is considering swapping a portion of the $13.4 billion it has loaned GM for an equity stake in the restructured company.

Key obstacles for both companies are on the labour cost side. Typically, all-in labour costs are cited because the Detroit Three have higher pension and benefits costs than the foreign transplants have as a result of the contracts negotiated with the unions in the past. In the U.S., the VEBA has provided some relief for retiree costs, though the automakers are looking to use equity rather than cash, at least for a portion, to pay into this fund. And while the gap has narrowed, UAW labour costs are still higher than those of foreign transplants. Ford renegotiated a deal with the union, which will slash Ford's labour costs to about $55 per hour (previously close to US$70 per hour) compared to $49 per hour at the foreign transplants. Chrysler and GM have also reached cost cutting agreements with the UAW, however the deals have not been ratified and the details have not been released.

Could the US operations survive and the Canadian fold?

The most likely scenario is a shared outcome between operations in Canada and the U.S. The obstacles facing the U.S. operations apply to those in Canada, including labour and legacy-related costs such as pensions. The social provision of health care in Canada is a competitive advantage. Still, there is a possibility that Canada's operations could cease even if U.S. operations continue. In fact, Chrysler has already threatened to relocate its Canadian operations to U.S. plants if further significant concessions aren't met. A major challenge is that the companies and the CAW don't agree on which costs should be used or compared to. The recent agreement between the CAW and GM is estimated to have lowered labour costs by $7 per hour from the current $75-78 per hour range. The union argues that based on an 80 cent exchange rate and a relative productivity advantage, this move brings costs into line with its U.S. operations.

While GM is quite satisfied with this agreement, other automakers argue that the exchange rate should not be factored in. Despite its relatively stronger position, Ford of Canada has joined Chrysler in arguing that the pattern agreement reached between GM and the CAW will not provide it with the savings it requires to remain competitive. Chrysler is looking to cut labour costs by $19 per hour, which would bring them inline with Toyota plants in Canada. While the CAW is resisting these concessions, it appears as though Fiat is now pressing for this deal to happen in order to secure a partnership with the automaker. As well, the Canadian government has echoed these demands, with Industry Minister Clement warning that if the CAW does not make further concessions – with both GM and Chrylser – Canada may call its loans.

What are the potential economic costs to Ontario's economy?

The major hit suffered by Ontario's economy if a company were to fold has been well documented. Together, the 3 companies account for nearly 2% of output and over 30,000 in direct employment. Of this total, 34% is attributable to GM, 38% to Chrysler and 27% to Ford. The economic costs would be amplified by the impact on parts as well as ancillary services.

Nonetheless, these impacts would likely be mitigated. For example, even if Chrysler moved its operations, its products would still be sold here, and several dealerships would continue to operate. Under the event of liquidation, some of the assets would be purchased and workers transferred. But bankruptcy or not, what is almost certain is that Ontario's auto sector will emerge smaller in the short term. However, these moves to improve viability would provide longer-term benefits.

What would happen to the pensions for Canadian autoworkers?

In Canada, while Chrysler's pension fund is almost fully funded, GM's pension fund is underfunded by over $6 billion. Should the automaker go bankrupt, it appears as though Ontario would be on the hook for those pensions. However, Premier McGuinty stated that the Pension Benefits Guarantee Fund – which was created to provide pensioners with up to $1000 per month should the company go bankrupt – has only $100 million available, and that fund is meant to cover all sectors, not just the automotive sector. GM is in talks with the provincial government in an attempt to resolve the pension situation.

How would Canadian auto parts companies be affected?

With auto production falling so dramatically over the past year, parts producers have suffered a significant drop in demand. Canada's key auto suppliers, Magna and Linamar, are larger and more diversified than many other parts makers, have more cash and credit, and thus should be able to weather the storm. However, several smaller companies have already gone bankrupt, and the rest are struggling to stay afloat. If GM and Chrysler were to file for bankruptcy, and several product lines or brands are cut, some of these parts makers would no longer be needed, and would also be forced into bankruptcy. Moreover, the surviving suppliers may be forced to renegotiate contracts with lower prices, which would weigh on their bottom lines. However, even if the automakers are able to avoid bankruptcy, the fate of many parts makers are at risk, depending on the future of the vehicles that they produce for.

The U.S. Treasury has allocated $5 billion in aid for parts producers to insure receivables should the automakers file for bankruptcy. Similarly, the Canadian government has provided a total of $1.2 billion worth of financial aid to suppliers through Export Development Canada's (EDC) accounts receivable insurance program. These programs will help suppliers a great deal, since receivables are a significant asset on their balance sheets. But even with this aid, many parts suppliers are at risk of going under as the automakers scale back operations and slim product lines. The sector accounts for about 1.3% of total GDP in Ontario, and employs over 60,000 workers in the province. These numbers will likely continue to shrink as automakers trim production.

Why has Ford been able to sidestep the woes of its Detroit counterparts?

Prior to the credit crunch, in 2006, Ford set up $23.5B worth of credit (using assets as security) which it has been using to finance its restructuring plans. This has left Ford in a much better financial position than that of Chrysler and GM, and the automaker has yet to require any government assistance. Furthermore, Ford has already completed much of what the government is asking of GM and Chrysler, including:

- Scaling back brands by selling Jaguar, LandRover, Aston Martin, and is looking to sell Volvo
- Cutting factory capacity to match demand – 17 factories since 2005; 50,000 jobs
- Keeping R&D spending alive

But while still surviving on its own, if auto sales remain this low, or deteriorate even further, Ford could eventually require some government aid. Moreover, if GM and Chrysler do file for bankruptcy, Ford could be in trouble as well, as the failure of some of their mutual suppliers will disrupt the supply chain.

Any hope that N.A. auto sales will soon turn the corner?

Sales in the U.S. are the most important for the continent-wide operations of all assemblers. And given that the U.S. economy is expected to contract for at least another 2 quarters, it is highly unlikely that we will see any uptick in sales this year. In fact, we forecast sales to average 9.5 million units in 2009, which is the lowest year on record going back to 1967. Moreover, while all automakers are taking a hit, the Detroit Three are feeling the brunt of it, with sales down 46% during the first quarter of 2009, compared to a 31% and 23% decline in Asian and European brands, respectively. With credit conditions expected to improve only gradually through 2010, and unemployment likely to continue to rise, big ticket items such as new cars will likely be near the bottom of consumers' shopping lists for at least the next 12-18 months. For a more detailed forecast, see the special report entitled "*Outlook for Auto and Parts* Sector" available on our website.

There are however, some upside risks to this forecast. While credit conditions in the U.S. are expected to improve slowly, GMAC, GM's main financing arm, recently announced that it will lower financing costs and begin to loan to subprime borrowers again – a move which they hope with stimulate sales. Furthermore, the U.S. government is considering implementing a scrappage program, whereby consumers would get a rebate on a new car purchase in exchange for trading in an old car. As well, there has been some chatter that Obama is also considering allowing taxes on new car purchases to be deducted from income tax. Should these incentive programs play out, and assuming that the rebate is large enough to entice buyers, we could see a bounce back in sales during the second half of this year. Still, sales will not likely reach pre-2008 levels within the next 2 years.

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