Fiat-Chrysler Merger With GM?

Fiat Chrysler Automobiles (FCA) chief Sergio Marchionne is proposing a potential merger with General Motors. In light of the conditions in today's auto industry, his reasoning is well-grounded in business strategy and economics.

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The automobile industry has many firms — none with a dominant market share. Firm strategies are quite similar, as each company strives to serve all market segments by offering a full line of products — small and midsize cars, SUVs, trucks, etc. — around the globe.

Companies compete for customers based on product differentiation, quality and brand identity. Innovation yields only temporary gains as competitors replicate the new product or feature.

The competitive landscape is influenced by a range of factors, including:

- Government regulations (e.g. safety, emissions, and mileage standards).
- Gasoline prices.
- Rapidly changing technology (e.g. autonomous driving, infotainment services, connected cars and car sharing).
- Potential competition from other business sectors (Google, Apple and Uber). As mechanical engineering gives way to computer-driven innovations, barriers to entry are falling.
- Cyclical customer demand: Purchases can be postponed in an economic downturn, leading to revenue volatility for automakers.

The automobile industry also requires a lot of capital. Manufacturing automobiles requires substantial investment in factories, equipment, and research and development. These costs are increasing due to the reduced cycle time of bringing new models to market, the rapidly changing technology landscape and increasingly automated production processes to reduce reliance on labor.

As a consequence of the large capital requirements, economic profits are less than other industries and tend to be negative. Economic profits adjust accounting profits by subtracting the costs of capital. This represents the difference between the profits earned in a particular activity, and the profits that could have been earned by investing the same resources in the most lucrative alternative activity.

The low economic profits can make it difficult for automobile companies to attract new capital by issuing stock or borrowing funds.

Automakers tend to fund capital requirements from internal operations and maintain large cash reserves. Ford Motor Co. in 2014 reported accounting profits of $6.3 billion but had an economic loss of $2.8 billion. The last time Ford had a positive economic profit was in 2004. In contrast, Apple has had a positive economic profit in each year since 2004 and an economic profit of $26 billion in 2014.

Against this challenging business environment, Marchionne's consolidation strategy is smart. A combined FCA-GM can realize economies of scale and scope, thereby reducing costs. An economy of scale occurs when average costs decrease as output increases. Cost savings are achieved by spreading product-specific fixed costs, purchasing, and research and development.

Kirk Kerkorian in 2006 urged GM to pursue a partnership with Renault-Nissan to save on purchasing costs. Companies can also combine support services such as human resources, legal, information technology, and accounting and finance.

An economy of scope is the cost savings a firm achieves by increasing the variety of activities it performs. For original equipment manufaturers (OEMs), this is having more components in common and making vehicles on a global architecture.

While this would be advantageous, the execution will prove problematic. Merging two large organizations is challenging due to potential differences and conflicts in organizational culture. Successful integration requires great leadership, people skills and change management.

Combining complex IT systems presents many challenges. Streamlining operations by closing factories in Europe or dealerships in the United States will face resistance.

GM is resisting the consolidation overture from Marchionne. GM CEO Mary Barra said, "We are merging with ourselves; we have scale; we have leveraged the appropriate opportunities."

Strategies to confront the challenging business landscape for OEMs will develop. Consolidation will take place as competitive pressures increase and the costs savings become more critical.

In the next five years, the number of auto companies will decline in the face of an increasingly dynamic and challenging business environment. *

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