The Fiat-Chrysler Deal: Looking For Good Returns From M&A

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Introduction

The automotive market, which has always been characterized by strong competitive pressure, has undergone drastic changes since the 1990s. This has had obvious implications for the management methods adopted by automobile manufacturers, who are fighting for survival. The change, which began in the early ‘90s, when the first strategic alliances between different industry groups were born, rose sharply as a result of the deep economic crisis that hit the Western European world at that time.

The EU market, and to a lesser extent that of the U.S.A, is unable to absorb the production capacity of companies installed in its territories. As a result, it is becoming increasingly difficult for generalist manufacturers to make these plants profitable, except for those in which products also intended for export are assembled. The sales figures are unequivocal: in Europe in 2007, 14,776,476 units were registered (Ansa, 2008), while in 2012, the figure drops to 12,053,904 (Ansa, 2012), representing a percentage decline of 20%. In the meantime, the sales trend in the United States reveals an improvement, although this is minimal. The phenomenon has not only affected the Fiat group, PSA (Peugeot - Citroen), Renault, Opel and the VAG national trademarks, Seat and Skoda, have also been affected by the contraction. Some of them did not survive, for example Saab, a Scandinavian company which was very popular in America during ‘80s and ‘90s. Others, however, in order to avoid the same fate, were sold to operators in emerging countries: Jaguar and Land Rover are now owned by Tata (India), while Volvo has been purchased by Geely (China) (Jullien, 2013).

The crisis hit generalist brands that offer products for which price is the main variable in purchase decisions. For high price products, however, substantial resources are required in order to continue technological development and guarantee product quality. Companies can remain competitive only if there are adequate gross product margins resulting in dividends for shareholders. These margins make it possible to approve future operational plans during the annual general meeting (Jullien, 2013).

In this scenario, the response of the automotive industry is reflected in an increasing number of cross-border mergers and acquisitions (M&As). Nevertheless, it should be noted that success is not assured, since empirical research indicates that more than 50% of M&As fail to achieve their purpose (Papadakis, 2005), and the percentage is even higher for cross-border M&As, which is due mainly to post-merger integration and cultural differences.

Several approaches can be identified through analysing the automotive market. For instance, in terms of evolution, the rate of technological change and the lifecycle can be taken primarily into account (Anderson, Zeithaml, 1984; Porter, 1985; Scherer, Ross, 1990; Dobrev, Carroll, 2003; Lei, Slochum, 2005), or one could focus on the competitive profile (Lei and Slochum, 2005; Hambrick and Fredrickson, 2001). Generally speaking, the main characteristics appear to be market maturity, a low rate of technological evolution and a generally constant market share in the medium term. Capturing and sustaining cost-driven efficiencies is therefore essential. In the light of this scenario, the main drivers for automotive companies are typically the following:

- focus on gaining access to wider markets in order to leverage fixed costs, maximizing the benefits of cost and process efficiencies in an attempt to achieve industry-wide economies of scale;
- avoiding products that require a high degree of customization, in favor of mass production and the distribution of products with highly standardized contents. It should be noted that the standardization of products, components and technologies may entail difficulties in appealing to many different market segments with a compelling value proposition for each;
- actively searching for new ways to reduce high capital intensity by sharing the risks of future product development (co-design) with suppliers, by outsourcing, or by becoming larger through M&As with competitors.

In relation to the latter driver, it is interesting to note that Grinblatt and Titman (1998) suggest that M&As can, by themselves, be potential sources of various gains, among which the following can be highlighted: 1. operational synergies, centered around cost reductions or synergies related to economies of scale or scope, lower distribution or marketing costs, or the elimination of duplicate assets; 2. market-power maximization, based on the notion that the acquiring firms can gain monopoly power through a merger, for instance by buying out competitors or foreclosing suppliers; 3. value creation, by introducing more efficient management procedures, if the acquiring firms recognize managerial shortcomings in the target firms (so-called disciplinary takeovers); 4. fiscal advantages, including changes that occur through mergers which reduce tax liabilities.

In M&As, the role of management in post-event integration is crucial. Haspeslagh and Jemison (1991) showed that the success rate was higher for acquisitions that integrate some members of top management of the acquired company, and particularly those most involved in managing critical functions. The creation of formal teams responsible for managing the post-negotiation phase is a condition for success which is maximized by the involvement of managers from the acquired firm. While a top-down approach in managing the acquired company seems to facilitate rapidity, consensus helps avoid the loss of competencies and resources resulting from the exodus of managers from the acquired firm (Walsh, 1988).

2. The Fiat-Chrysler case

From an industrial point of view, the Fiat situation in 2009 was characterized by ups and downs:

- Fiat Professional, the LCV (Light Commercial Vehicles) brand, was well-positioned in the European rankings, with 12.8% of the market share. Fiat held a position of absolute strength in South America and, more specifically, in Brazil, where the company was the market leader and its activities were very profitable for a decade, generating the majority of the company's EBIT (Earnings before Interst and Tax);

- Fiat was a European leader in terms of technological solutions for CO_2 emission reduction;
- The Fiat Group's margins were solid and very much in line with the average of the automotive industry, even in periods of higher pressure as a result of adverse macroeconomic conditions.

On the other hand, despite occupying a good position in one of the most important markets, for all other BRIC countries, the market share was clearly inadequate, not to mention the situation in the very competitive and difficult European market:

- Profitability appeared to be too heavily dependent on LCVs; the total volumes of Alfa Romeo and Lancia were not sufficiently powerful to ensure the brand self-sustainability for the brand;
- The main Italian production plants were underutilized;
- Finally, the sales distribution of Fiat Group by automobile segment was too imbalanced towards mini and small segments (eg. Panda and Punto), which together comprised over 77% of the groups' registrations in Europe, whereas the total European registration distribution showed a clear predominance of small, compact and large segments, as well as a characteristic presence of MPVs and SUVs.

To sum up, the situation of Fiat in 2009 could be regarded as a serious standoff: the growth momentum propelled by group turnaround was stifled by the global crisis, which in turn led to contracted revenues and higher levels of caution towards investments, even with respect to new models. Moreover, some sales targets were missed; this fact led firstly to a revival of the Lancia and Alfa Romeo brands and to the acquisition of a stable presence in all emerging markets, particularly China. Further growth of Fiat Group appeared to require a major review of the previuos strategy (e.g. targeted alliances). The crisis situation of Chrysler, the crisis of the automotive market in the US - generated by the broader financial crisis and peaking with the bankruptcy of Lehman Brothers in September 2008 - along with the opportunity for an acquisition, all combined to offer the perfect occasion for a strategy revolution.

On the other side of the Atlantic Ocean, after the failed merger with Daimler-Benz and the acquisition of the company by the investment firm Cerberus Capital Management, Chrysler began 2009 with a degree of financial and economic instability that led to bankruptcy (Caputo, 2012). The continued decline in sales over the last ten years had brought the number of cars sold down from 2.6 million in 1999 to 1.4 million in 2008 (Chrysler Group LLC Annual Sales Reports, 1999-2008). In order to survive and repay its maturing debt obligations, Chrysler received some funding from the U.S. government in late 2008. However, the debts were tied to the achievement of a satisfactory turnaround plan, for which it was necessary to find an industrial partner which would provide advanced technologies. This was the main reason for the tentative agreement with Fiat. The CEO of Fiat, Marchionne, (2008) said:

"We need to bring people around the table and say: Look guys, the party is over. Somebody called our bluff and we're not all going to make it so let's fix it. It may be painful. It may be ugly. But if we want to do the right thing for this industry, let's do it now. You need at least 5.5 million to 6 million cars [a year] to have a chance of making money. It is not just the absolute number of cars that matters, but the volume associated with each architecture. Fiat is not even halfway there. And we are not alone in this. So we need to aggregate, one way or another. "… *"Maybe I am completely wrong, but today my gut instinct is to be truly Draconian. By the time we finish with this, in the next 24 months, as far as mass-producers are concerned, we're going to end up with one American house, one German, of size; one European-Japanese, probably with a significant extension in the US; one in Japan; one in China and one other potential European player."…* "*I can't afford to spend half a billion [euros] on doing a platform. It's not that I don't have it. I just cannot stand up in front of a shareholder or any other provider of capital and say that I am going to make a reasonable and certain return on this investment. Those days are gone."* … "*The problem with car guys is that they always thought that they were at the upper end of the food chain and, unfortunately, we are all sitting at the bottom. And now the world has told us so." …* "*We have tried every trick in the book. We sold financial services. We bought financial services. We sold the supplier base. We took back the supplier base. We have done all the monkey acts corporate life allows you to do".*

The agreement

The final agreement was signed on June 10, 2009. The beginning of the negotiation process, which led to the creation of the agreement, can be traced back to January 20, when Fiat and Chrysler jointly signed a non-binding letter of intent for the creation of a 'global strategic alliance'.

According to the "January 20" agreement, Fiat would provide licenses permitting Chrysler to make use of platforms in its plants for the production of its fuel-efficient vehicles, engines, transmissions and components. The two companies would also have had access to each other's distribution networks (Caputo, 2012).

The letter of intent states that Fiat would have received an initial 35% stake in Chrysler, with an option to purchase an additional 20% after twelve months. For Fiat, the agreement would have meant gaining access both to selling technologies resulting in significant investments, and to markets with great potential, through the launch of brands such as Alfa Romeo and Fiat 500. It would thus resume the path of internationalization in the U.S., which had already been initiated and then abandoned by the company several times in the second half of the twentieth century. For Chrysler, on the other hand, the agreement with Fiat was a major part of the recovery plan that it submitted to the U.S. government and was consistent with the terms and conditions for the granting of the received funds: corporate restructuring and the conversion of production processes towards environmentally-friendly vehicles.

In terms of governance, Fiat and Chrysler Group shared the same CEO, and an adaptation towards the latter company was imposed. At the same time, top management from Chrysler was involved in the restructuring process from the outset and the Group Executive Council of Fiat-Chrysler was opened up to managers from both organizations. Moreover, some managers from Fiat were asked to join Chrysler's teams to help with the process of integration and share their competencies. Furthermore, some managers from Chrysler were asked to move to Turin. Generally speaking, the basic approach for defining the new Chrysler organization was to make the best possible use of any local resources, minimizing the introduction of managers from Fiat (5 Italian team members of 26 in the Chrysler management team).

The new entity: Fiat-Chrysler

The acquisition of Chrysler provided Fiat Group with the opportunity to substantially re-define its strategy, markets and products. First of all, the new Fiat-Chrysler entity acquired wider and diversified reference markets, through the addition of the North American market to the European and South American ones (Bank am Bellevue, 2012; Palmer, 2012). Data related to the geographical breakdown of revenue shows that the group market is strongly diversified, with a major shift from the home-region orientation (Rugman, Collinson, 2004) of Fiat ex-Chrysler in 2010 (with 60% of revenues generated in Europe and 28% in Latin America), to the almost global dimension of the Fiat-Chrysler combination in 2011 (with 30% revenue generated in Europe, 47% in North America and 17% in South America).

Nevertheless, if trading profit is considered in terms of revenue origin, there is a clear predominance of the North and South American areas above all others, while Europe barely breaks even. From this point of view, the integration with Chrysler yielded the advantage of further strengthening the historical solidity of the Latin American region through the positive results from the North American region. In terms of market share, the combination of Fiat and Chrysler reference markets enables the new automotive Group to play a major role in the Western area, from Europe to the entire American continent. Nevertheless, it should be noted that both Fiat and Chrysler maintain a reference role in their respective historical markets (Europe and Brazil for Fiat, North America and Mexico for Chrysler) and that, so far, neither Fiat nor Chrysler have acquired significantly more favorable positions in the markets that are historically more linked to their partner. Thus, even if they are almost "global" from a consolidated point of view (if a fourth area is taken into account, that is South America, according to the strong growth of Brazil above all), Fiat and Chrysler still remain "bi-regional" or "home-region" if considered singularly on their own.

The new Fiat-Chrysler entity commenced a strong process of integration and standardization that optimized design and distribution costs by achieving broader economies of scale. This standardization strategy focused primarily on components that are substantially transversal to all architectures and that constitute 70%-75% of total vehicle costs (for instance powertrain technology, lighting, instruments, steering systems). Attention was therefore not paid to the remaining components (for instance, interior and exterior trims, seats, instrument panels, exterior and interior lightning) that are highly specific and characterize model and brand identity. On the other hand, Fiat-Chrysler focused on the minimization of basic vehicle architectures, targeting three modular architectures shared by both Fiat Group and Chrysler (mini, small and compact), two specific architectures for LCVs, and low-cost vehicles as well as four Chrysler architectures inherited from models already in production.

Another strength of the Fiat-Chrysler deal is the potential for sharing low-consumption engine technologies in order to optimize the powertrain scenario in the North American market, which is dominated by gasoline engines with medium-high engine capacity. For instance, in 2010, Chrysler had 91% gasoline engines, of which 54% were 6-cylinder and only 19% 4-cylinder (the closest to European standards). In order to increase power, high displacement engines were typically used, at the expense of consumption and pollution. Regulations originally introduced in California and progressively adopted by an increasing number of other States, by contrast, defined severe threshold limits for both fuel consumption and CO_2 emissions. The strategy was then to leverage the experience of Fiat in the powertrain field. Generally speaking, what would be changed significantly is not the prevalence of diesel engines (actually linked to final customers' choices and culture), but the proportion of medium-high displacement gasoline engines, together with the doubling of 4-cylinder engines , while halving the total number of engine families.

The focus on the World Class Manufacturing (WCM) philosophy, which was extended progressively to all Fiat-Chrysler and Fiat Industrial plants, was expected to yield substantial savings, first of all in terms of product quality and reliability. It was anticipated that Fiat and Fiat Industrial, quite experienced in WCM, would generate 1.9 billion Euros of savings in the period 2010-2014. Chrysler, which implemented the WCM approach just after the acquisition by Fiat, had a target of 1 billion Euros of cumulative savings during the period 2010-2014.

The merger of the purchasing needs of three actors as significant as Fiat SpA, Fiat Industrial and Chrysler made it possible to reach a mass large enough to generate consistent savings on purchases. While in 2009, the total volume of purchasing generated by the combination of Fiat and Fiat Industrial exceeded 20 billion Euros, in 2011, it exceeded 50 billion. In terms of savings from purchasing volume improvement, in the period 2010-2014, it is expected that Fiat-Chrysler and Fiat Industrial will reach total savings of over 5 billion Euros, with an average of 2.1%-2.2% every year.

As stated above, one of the main issues faced by companies operating in a mature market such as the automotive one is that of becoming slow in taking decisions and thus failing to react effectively to market change. Another issue is that the prevailing functionality of products in the automotive market now exceeds that which can be utilized by customers (Christensen, 2001). Consequently, making even better products no longer yields superior profits. Instead, innovations that enhance a company's ability to bring products rapidly to market – and to customize offerings in a responsive, useful manner – become the mechanism for achieving an advantage. It is well known that one of the Fiat Group's main and historical advantages is its extremely compressed timing for new model development. Following a continuous series of development process refinements, the Fiat Group is now able to achieve a market launch from technical release in 18 months. This timeframe, which enables the Group to be relatively faster in responding to market demands than its competitors, is achieved by means of a series of strategies, including the extensive use of virtual simulation instruments, structuring of the engineering process, early involvement of suppliers, and standardization of components and architectures. This approach, and the consequent advantages, was also intended to be shared with Chrysler, where development timing offers wide margins for improvements (of up to five months less) (Fiat Investor Day, 2010).

Finally, Fiat-Chrysler is expected to offer a wider and more diversified product mix offer, minimizing (but not eliminating) the gap between with the average product mix on the European market. Taking into account data from September 2011, the relative weight of low segments has decreased progressively in favor of segments with less coverage historically, such as the compact segment and SUVs (thanks to the fundamental contribution of the Jeep brand).

In relation to the advantages of M&As already mentioned, as highlighted by Grinblatt and Titman (Grinblatt, Titman, 1998), namely operating synergies, market-power hypothesis motivations, disciplinary takeovers and tax motivations, most of the abovementioned gains can be recognized in the Fiat-Chrysler deal. Fiat acquired a competitor (strictly speaking, not a direct one), introduced a more effective approach to management in Chrysler and achieved several operating synergies. Generally speaking, through the acquisition of Chrysler, Fiat turned from a niche player (i.e. Italy/Brazil and A/B small car segment) into a 'full liner' automotive car company. Moreover, the industrial plan presented by Fiat in April 2010 in Turin was a mirror image of the Chrysler plan, which was presented in November 2009 in Detroit. By utilizing each company's strengths and core competences, both plans were directed at creating the most unified strategic partnership, aiming for an 'operational' merger before a more comprehensive financial tie-up could be considered.

After the alliance with General Motors (which secured the survival of the Opel brand, thanks to technology from Fiat Power Train), Fiat attempted to meet global challenges with a new covenant and with a different form. This was no longer a joint venture, but rather a progressive real merger with Chrysler. The aim was to create common synergies in terms of brand management. In North America, Chrysler allowed Fiat and, subsequently, Alfa Romeo to make use of its sales and service network. In South America, it will be Jeep and Chrysler that benefit from Fiat's leadership in markets such as Brazil. In Europe, however, Fiat will remain a generalist brand which is dependent on the lower part of the market, supported by the 500 brand, which will continue to develop its own distinct identity. Alfa Romeo will be a leading player in the medium-high part of the market, positioning itself through the characteristics of sportiness and elegance. It is likely that Lancia will be sacrificed, as a result of the overlap with Chrysler, which has a similar identity. Ypsilon marketing in the UK is under the American brand. Jeep, on the other hand, will form the basis from which to extrapolate 4x4 technology and know-how for be transfer to the SUV (Sport Utility Vehicle) segment. Given the trend over recent years, it will no longer be a market niche, as in the past, but represent a real and autonomous segment (Balcet, 2013).

The aim is to produce at least 6 million cars every year, as stated by Sergio Marchionne (CEO of Chrysler and FGA) (Reuters, 2014). In order to achieve this goal, it is essential to revisit how operations are managed on a global level and optimize the use of all available resources, implementing world class manufacturing, increasing the production scale, reducing times to market, and standardizing components (Roveda, 2013). The standardization process is carried out by Fiat, which is currently moving towards the adoption of only five platforms, mainly for the Mini, Small and Compact size.

The most significant size for the competitive strategy should be the Compact, which in the past emerged from the Bravo and Delta models, and now, in its latest evolution, forms the backbone of the Giulietta model. Moreover, thanks to a number of modifications, it was adopted by the Fiat Linea and the Dodge Dart. This is the first product to be developed entirely under the auspices of the new FGA- Chrysler (Balcet et al., 2013).

Brief critical summary of the case

Taking into account the approach suggested by Colombo and Conca (2001), the more recent Fiat-Chrysler case appears to be an integration process of one partner, with another that needs to be restructured in order to gain profitability. Thus, on the one hand, Chrysler was in a very difficult situation in 2009 restructuring was necessary for it to recover positive industrial and financial results. On the other hand, integration between Fiat and Chrysler was, and still is, necessary for achieving and optimizing the advantages from the acquisition. A mixture of both the abovementioned "top-down" and "bottom-up" approaches was therefore applied. Fiat shared its top management with the Chrysler Group and imposed a turnaround on the latter. At the same time, management from Chrysler was involved from the outset in the restructuring process, and the Group Executive Council of Fiat-Chrysler was opened up to managers from both organizations.

Moreover, some managers from Fiat were asked to join Chrysler's teams to help with the process of integration and share their competencies, and vice-versa. Generally speaking, the basic approach adopted for defining the new Chrysler organization was to make the best possible use of local resources, thereby minimizing the introduction of managers from Fiat (five Italian team members out of 26 in Chrysler's top management team).

On the first day Marchionne made a speech to all Chrysler employees in which he set out the objectives (Marchionne, 2008):

1. *"With your leadership, here's what we'll see:*
    a. *A company with the ability to move and change, with individuals who know how to adapt, react quickly and outpace the competition.*
    b. *Within 90 days we'll have defined a full-line product portfolio for each brand that will line up with the best in the world – from the smallest world-class sub-compact cars to the largest hybrid Ram pickups.*
    c. *A manufacturing organization that is absolutely world class.*

d. *A vehicle development organization that is working at its peak, as we launch one new product after another.*

e. *A procurement organization that will achieve savings on components shared across a volume global product line with common architectures and common cost targets.*

f. *Growing international sales.*

g. *A flat Chrysler organization that makes decisions, that takes action and offers opportunities for anyone with the talent and will to make a strong contribution.*

h. *Do all of that, and within 36 months we'll have a new Chrysler that meets its financial, moral and ethical obligations … and establishes itself as the best car company in North America. "*

From an industrial perspective, the product philosophies of Fiat and Chrysler were fairly similar; to produce popular cars for their respective market (not considering Maserati and Ferrari). Contrary to the Daimler-Chrysler case, the reference markets and product segment distribution of Fiat and Chrysler were in fact complementary, and no harm would be done to the partner's brand image through the integration process.

3. Conclusions

From the above case, it appears that one of the main issues that needs to be addressed in the quest for a successful cross-border merger is a higher degree of integration of the two merging entities, from industrial and financial points of view. Products and markets therefore need to be complementary and compatible, so that the positive effects of economies of scale through the sharing of purchasing and technologies can be fully leveraged. Finally, in order to achieve a satisfactory level of integration, both entities must be willing and able to work together and focus on the same overall objective.

In the Fiat-Chrysler case, both Groups were highly motivated achieve a common goal. On the one hand, for Fiat, the deal represented the ideal occasion for a revolution of its strategy, offering excellent growth opportunities for the Group. On the other hand, Chrysler received some funding from the U.S. government, on the condition that it achieve a satisfactory turnaround, for which it needed the rightpartner. The alternative for Chrysler would have been bankruptcy.

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