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Int'l Cover Story- Europe

DAIMLER & CHRYSLER (int'l edition)

What the deal would mean

The champagne was on ice at the Dorchester Hotel in London. Earlier in the day on May 6, the board of Chrysler Corp. and the management board of Daimler Benz approved a historic merger, creating a \$130 billion automotive colossus known as DaimlerChrysler AG. The chief executives of two of the world's largest auto makers, Chrysler's Robert J. Eaton and Daimler's Jurgen Schrempp, strode across the room and sealed the largest merger in automotive history--and the third-largest deal ever--with a handshake. The mood was electric as the assembled executives prepared to pop the cork on a pact that would send shock waves around the world. "Both men were enormously energized," says a source close to the deal.

And why not? It looks like a marriage made in automotive heaven. In one bold stroke, the pending merger of Daimler and Chrysler dramatically changes the landscape of the global auto industry. By combining forces, Daimler, Germany's biggest industrial concern, and Chrysler, America's No.3 carmaker, bring a range of hot-selling models and formidable financial muscle under one garage roof. Simply said, DaimlerChrysler is set to transform the way the auto industry operates worldwide.

The megadeal, which was set to be formally announced on May 7, unites two of the world's most profitable auto companies--with combined 1997 net earnings of \$4.6 billion. And if ever a merger had the potential for that elusive quality--synergy--this could be the one. Mercedes-Benz passenger cars are synonymous with luxury and sterling engineering. Chrysler is renowned for its low-cost production of trucks, minivans, and sport-utility vehicles. Chrysler is almost wholly domestic, and Mercedes is increasing global sales--albeit within the confines of the luxury-car market. By spreading Chrysler's production expertise to Daimler operations and merging both product-development forces, the new company could cut costs by up to \$3 billion annually--including \$1.1 billion in purchasing costs,

analysts say.

But DaimlerChrysler is about more than cutting costs and filling product and geographic gaps. It's about the emergence of a new category of global carmaker at a critical moment in the industry--when there is plant capacity to build at least 15 million more vehicles each year than will be sold. And overcapacity is expected to balloon to 18.2 million vehicles by 2002 as Asia continues to decline, predicts Standard & Poor's DRI, a division of The McGraw-Hill Companies. Consolidation is inevitable; from about 40 auto companies now, to about 20 in the next century, says DRI analyst Sam Fiorani.

DaimlerChrysler, then, may be the first member of the 21st century 20. "The Mercedes-Chrysler deal sanctions the concept of auto mergers and is a major catalyst for more," says Joseph S. Phillippi, auto analyst for Lehman Brothers Inc. Eaton, in an Apr. 27 interview with BUSINESS WEEK, predicted that Western auto makers with the wherewithal would snap up the troubled auto makers of South Korea and Southeast Asia. General Motors Corp., for example, is considering a big stake in Korea's beleaguered Daewoo. In Europe, auto makers such as Volvo, Fiat, PSA (Peugeot/Citroen), and Renault are ripe for takeover.

DaimlerChrysler will have the wherewithal. It will have \$130 billion in annual sales and assets totaling \$120 billion. It will have factories on four continents.

Indeed, both partners were giants in their own right. So why merge? Top executives at the two companies came to realize that if they continued to go it alone, their companies could survive as strong regional players--but might be forced onto the shoulder in a global industry. "There are world forces at work that are driving consolidation," Eaton said in the April interview. "Two factors are huge: the worldwide excess capacity in autos and the Asian economic crisis."

Eaton and Schrempp hatched their stunning plan in secret meetings over the past nine months in Germany and Detroit. Daimler was represented by Goldman, Sachs & Co. and Deutsche Bank, while CS First Boston represented Chrysler. The estimated \$40 billion deal is being financed by a stock swap of two Chrysler shares for every one Daimler share. It will leave Chrysler shareholders with 43% of the combined entity, while Daimler stockholders control 57%, say sources familiar with the deal. That will make DaimlerChrysler a German company for tax and accounting benefits, these sources say.

But the company will have dual headquarters. A source close to Daimler says that Daimler and Chrysler headquarters will remain in Stuttgart and Auburn Hills, Mich., for some time to come. "Can you imagine Daimler leaving Stuttgart? Can you imagine Chrysler leaving Detroit?" It will also have co-CEOs--to start. After three years, however, Eaton is expected to retire, allowing Schrempp to take full control, says sources familiar with the

arrangement.

Investors immediately applauded--pushing Chrysler shares up 7 3/8 to 48 13/16 on May 6. "Chrysler has the trucks, vans, and SUVs, and Daimler has the luxury cars," says Seth M. Glickenhau of Glickenhau & Co., an investment firm that holds 8 million Chrysler shares. "There are enormous synergies in product."

One of the biggest opportunities is for the paired company to plunge into new markets that neither could assay alone. Neither has much of a presence in Latin America or Asia, although Daimler does sell heavy trucks there. Chrysler's inexpensive small cars will give Daimler a vehicle to drive into emerging markets. "With our [upscale] product portfolio, we will never be a mass marketer," says a source close to Daimler. "There are some markets where [Mercedes] will never be able to have an impact."

The first venture of the new merged company likely will be a barebones little car, smaller than Chrysler's subcompact Neon model, to sell in Asia and Latin America. "We would like a sub-Neon vehicle for the international market," says Eaton. "We started looking at projects four years ago, and it's something we're looking at harder now." Ironically, such a car may be powered by engines to be made in Brazil in a joint venture between Chrysler and BMW--Mercedes' archrival in Germany. BMW declines to comment on the DaimlerChrysler union.

Indeed, most rivals are too stunned to react. Both Ford and GM declined to comment. On the other hand, many industry watchers immediately questioned whether the enormously divergent cultures of Auburn Hills and Stuttgart won't get in the way of all that synergy. "I can't imagine two more different cultures," says Furman Selz auto analyst Maryann N. Keller.

Chrysler's brushes with bankruptcy forged a culture dedicated to speedy product development, lean operations, and flashy design. Daimler remains a buttoned-down, engineering-driven bureaucracy known for conservatively styled products. "The reaction here is shock, excitement, enthusiasm, and concern," says one Chrysler exec.

Schrempp and Eaton are certainly an odd couple. Eaton, 58, is a Kansas-born engineer who worked his way up the ranks at GM before replacing Lee Iacocca as Chrysler chairman in 1993. His soft-spoken manner belies his reputation as a savvy manager. When he took the job at Chrysler, Motown observers expected that his rival, Robert A. Lutz, would bolt. Yet Eaton and Lutz came together to drive Chrysler to record sales and profits. Lutz, 66, now vice-chairman, is expected to retire soon.

Schrempp, who once trained as an auto mechanic, is also an engineer who climbed the corporate ladder to become CEO in 1995 after 28 years with Daimler. After he won the top post, he forced out his rival for the job, Helmut Werner, who had engineered a turnaround with hot products, like the M-class sport utility vehicle and SLK roadster, and youthful, irreverent

marketing.

Can Chrysler and Mercedes live together? It could be tough because they will want to protect their vastly different brands. The Mercedes network "is not the kind of distribution system that Chrysler wants or needs, or even could use," says Keller. Nor is it likely that a Mercedes sedan will one day roll down a Chrysler line. "People buy Mercedes because they think they're made by guys in white coats," says Keller. "That image better not be contaminated by the idea that it's being built by a bunch of guys in Indiana."

So how will Chrysler and Mercedes help each other without losing their identities? Chrysler's slowly improving quality could take a quantum leap forward with help from Daimler engineers. And Daimler's diesel engines, for example, could help Chrysler in its efforts to sell subcompacts and minivans in Europe and elsewhere. Chrysler, for its part, has the industry's best supplier relations, while Daimler still relies on strong-arm techniques to get lower prices from its suppliers. Together, they can save on warehousing and logistics for cars and spare parts in both Europe and the U.S. They also can jointly make internal components like air-conditioning systems and door latches and pool their resources in developing basic technology.

Well before anyone knows if DaimlerChrysler is a success, however, its very existence could reshape the industry. Look for auto makers to scramble for partners to ensure survival as one of the 21st century 20. How that plays out is anybody's guess. "The odd man out here seems to be the Japanese," says Phillippi of Lehman Brothers. "Nissan and Honda in particular have only two legs to stand on: North America and Japan." That won't be enough in this race.

By Bill Vlasic, with Kathleen Kerwin, in Detroit and David Woodruff in Frankfurt with Thane Peterson in London and Leah Nathans Spiro in New York

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BusinessWeek

Updated May 7, 1998 by bwwebmaster
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