

Toyota's New U.S. Plan: Stop Building Factories

Contributed by Norihiko Shirouzu, Wall Street Journal
Wednesday, 20 June 2007

Five years ago, Toyota Motor Corp. launched a factory-building blitz in the U.S. that helped make it the world's largest auto maker. Now the architect of that push and a senior member of the company's founding family are both urging a new strategy for the U.S. -- hit the brakes. Top Toyota executives are concerned that the car maker may have built too many U.S. factories, in part to build political support by providing new jobs in lots of places. And although Toyota's U.S. sales continue to grow, these executives worry about an uncertain outlook.

At the same time, a cheap yen is making it advantageous for Toyota to increase manufacturing capacity and export cars from Japan. "It's much, much more profitable to produce cars in Japan and ship them all to the U.S. right now, if it wasn't for the political problems that might cause," says a senior executive and management-board member. Toyota has increased shipments to the U.S. of Japanese-made vehicles from 762,000 in 2004 to 1.27 million last year.

Toyota's planned slowdown in U.S. factory building, and a parallel effort to rein in rising labor costs, suggests a rare misstep for the Japanese giant.

Over the past decade, it gobbled up market share by anticipating the appetites of U.S. car buyers better than its Detroit competitors, rattling the beleaguered American industry and supplanting General Motors Corp. as the world's No. 1 auto maker. Now, Toyota's far-flung U.S. plants have created logistical tangles that have raised the cost of doing business. The reaction inside Toyota's executive offices -- ignited by the oracular input of two elder corporate statesmen -- shows the company scrambling to keep its lead in a tough U.S. car market.

For Toyota, building factories in the U.S. has served as a way to win goodwill in the face of public rancor over the role played by foreign auto makers in the decline of the American auto industry. In Japan, most of Toyota's factories are clustered in a single place, Toyota City. In the U.S., over the past decade, Toyota has spread factories from Fremont, Calif., to Georgetown, Ky. For states whose efforts to attract one have thus far fallen short -- including Michigan -- Toyota's strategic shift means that new factories aren't likely any time soon.

In the automobile industry, having too much manufacturing capacity is bad business. Last year, Toyota began producing its redesigned Tundra pickup truck at a new factory in San Antonio, its second plant dedicated to that model. Then rising fuel prices took a bite out of large pickup sales, leaving Toyota with a problem it has rarely experienced during 30 years of U.S. growth: excess capacity.

Toyota can now make more than 100,000 more Tundras each year than it expects to sell. The sluggish demand and competition from Detroit have forced Toyota to offer unusually large discounts on Tundras, including zero interest financing for five years -- a tactic borrowed from GM.

"It's time for us to strengthen the fundamentals in all areas" in the U.S., says Toyota President Katsuaki Watanabe. He cites problems including rising manufacturing costs, excess capacity at some plants and quality problems.

In 2005, Toyota recalled 2.38 million vehicles in the U.S., slightly more than it sold that year. To improve engineering and design, Mr. Watanabe has said, Toyota will delay introducing some models by as much as six months and will eliminate others.

Despite the problems, the U.S. is likely to remain one of Toyota's most profitable markets. A recent shift by U.S. consumers back to more fuel-efficient cars has helped increase Toyota's U.S. sales even as Detroit's auto makers struggle. Toyota has increased U.S. market share over the past decade with a string of popular vehicles ranging from the Camry, the nation's best-selling sedan, to the Prius, a fuel-efficient gasoline-electric hybrid. The company became known for its dedication to quality, its efficient manufacturing, and for keeping costs lower than Detroit's Big Three.

But the plant-construction slowdown -- coupled with Mr. Watanabe's decision to reduce the pace of product launches -- means Toyota's revenue and profit growth could slow. It could also jeopardize Toyota's effort to increase its operating margin to 10% or above and to sustain it there.

Toyota's rethinking of plant construction began with a flurry of questions about its plans for an assembly plant on the outskirts of Tupelo, a northeastern Mississippi town near the birthplace of Elvis Presley. The Tupelo plant, scheduled to start production in 2010, will be Toyota's eighth North American vehicle-assembly plant and the fourth new one it has authorized in the past five years.

Criticism came from two of the company's most respected statesmen: Former Toyota Chairman Hiroshi Okuda and Honorary Chairman Shoichiro Toyoda, a key member of the company's founding family. Mr. Toyoda was the company's president from 1981 to 1992; Mr. Okuda, from 1995 to 1999. Both are members of Toyota's board of directors. Although

they have no executive roles, both still attend meetings of top executives and exert strong influence over management strategy, particularly Mr. Okuda. As Toyota's chief executive during the mid-1990s, Mr. Okuda was the chief architect of the auto maker's aggressive expansion outside of Japan.

In a series of high-level meetings last fall, Mr. Okuda, with Mr. Toyoda's support, began questioning management's rush to further expand its North American manufacturing capacity, according to several senior executives and board members.

At that point, the company had already been assessing new sites for months, stirring government officials in at least a dozen states. Its goal was to expand manufacturing capacity for its popular Highlander wagon, essentially a sport-utility vehicle built on the chassis of a midsize sedan.

Toyota executives such as Dennis Cuneo, then a senior executive of Toyota North America, began showing up in Southern towns like Tupelo, whose furniture industry had been hit hard by globalization. By September 2006, Toyota had a shortlist of sites including Tupelo; Marion, Ark.; Chattanooga, Tenn.; and towns in Georgia, Kentucky, Virginia and North Carolina.

In Tupelo, teams of Toyota employees began collecting information about land ownership, labor availability, and local cultural attitudes toward the Japanese, among other things, says Mississippi Gov. Haley Barbour. State and local officials were on standby to answer questions from Toyota. "If an ox fell into a ditch, we got the ox out of the ditch within 24 hours," the governor says.

At one point, Toyota said that no homes could stand within about 5,000 feet of the plant's paint shop, so that residents wouldn't be endangered by chemicals in the event of an accident. The Tupelo site had more than 10 homes within that radius, most of them mobile homes. Within 36 hours, Gov.

Barbour says, the state had an option to purchase every home and plans to relocate occupants.

But early last fall, at a meeting of Toyota's top executives on the 14th floor of Toyota's global headquarters building in Toyota City, Mr. Okuda began asking questions. With Mr. Toyoda's support, he questioned whether top executives were becoming "a bit complacent" with manufacturing-capacity expansion, recalls one senior executive, and whether they viewed the rapid plant building in the U.S. as a given, according to several senior executives who attended.

There were signs that sales weren't keeping pace with the increases in U.S.

production capacity. In addition, it was becoming more expensive to build cars in the U.S. because the costs of materials and labor were rising, according to the executives. Messrs. Okuda and Toyoda "were concerned we were becoming too happy-go-lucky, and that we were rushing to build plants, with investments becoming too lavish," according to the senior executive.

Mr. Okuda, who the company said was unavailable to be interviewed, wanted to know whether each project was really "given a thorough review" with a long time horizon in mind, according to the senior executive. Mr. Okuda asked if it was wise to keep adding plants rather than tackling pressing issues such as quality problems.

Toyota's decisions to add plants in the U.S. have always involved more than maximizing manufacturing efficiencies. The company has long been concerned about a resurgence of trade tensions. That could lead to protectionist measures such as import quotas, which limited U.S. sales of Japanese vehicles between 1981 and 1994.

Toyota has pledged to produce in North America at least two-thirds of the vehicles it sells in the region. It regards building more vehicles in the U.S. as a form of political insurance. By sprinkling manufacturing jobs across many states, Toyota built a network of state and federal politicians friendly toward the company.

Toyota operates vehicle, engine and parts factories in eight states -- California, Kentucky, Texas, Alabama, West Virginia, Indiana, Missouri and Tennessee.

Although Toyota enjoys a significant cost advantage over Detroit's unionized factories, spreading out its operations raised the cost of doing business.

Messrs. Okuda and Toyoda raised several specific concerns.

Toyota's most efficient plants around the world operate more than one assembly line each. Between 2002 and earlier this year, Toyota announced four new vehicle-assembly sites -- Tijuana, Mexico; San Antonio; Woodstock, Ontario; and Tupelo. Not one of the four has plans for a second assembly line. Only Tijuana and San Antonio are currently up and running.

In Japan, some of Toyota's plants are capable of building more than a half-dozen different vehicles. In North America,

several of them build just one or two models. That lack of flexibility makes it more difficult for the company to adjust to sudden swings in demand.

Messrs. Okuda and Toyoda also expressed concern about rising wages at Toyota's U.S. plants, all but one of them nonunion. To date, Toyota has matched United Auto Workers wages for tens of thousands of Toyota factory jobs. In Georgetown, Ky., for example, it pays an average wage of \$26 an hour. Although that's a bit less than UAW workers get at GM or Ford factories, bonuses that Toyota pays twice a year to hourly workers more than make up the difference. (U.S. auto makers have long complained that generous health-care and pension benefits they provide union workers and retirees have saddled them with a \$30-an-hour labor-cost disadvantage.)

Discounting health-care and pension benefits, Toyota workers are among the highest-paid manufacturing workers in the U.S. Toyota executives had reason to be concerned about labor costs: A weaker yen has made U.S. costs relatively higher, and efforts by the Big Three to cut labor costs threaten to erode Toyota's competitive edge. Toyota executives project U.S.

manufacturing labor costs will rise by \$900 million by 2011 because of a growing labor force and expected increases in wages and benefits, according to a recent Toyota study.

Toyota's North American executives had already been looking for ways to reduce manufacturing and operational costs at its next U.S. plant. But the concerns raised by Messrs. Okuda and Toyoda made it more urgent to find a "low-cost business model" for the U.S., according to one Toyota executive.

Executives decided that North American plants, starting with Tupelo, will adopt certain innovations currently being introduced in Japan. For example, Toyota has developed a shorter assembly line that can churn out a dozen different cars nearly simultaneously, on the same line -- one every 50 seconds, one of the fastest production speeds in the world. Toyota also aims to outfit each U.S. plant to produce a variety of models, giving the company more flexibility to adjust to shifts in demand.

In addition, it plans to reduce U.S. labor costs by revamping its pay policies, aligning hourly wages for new hires more closely with prevailing manufacturing pay in the regions where each plant is located. Executives say they have no plans to cut hourly wages of its current U.S. factory workers.

New hires, however, will be paid no more than about 50% over the prevailing manufacturing wage in the area.

That policy means that in Tupelo, where the average manufacturing job pays about \$14 an hour, Toyota workers would likely make no more than about \$20 an hour. In addition, Toyota intends to use more temporary workers, who typically get paid about half of what regular workers make and have few or no fringe benefits.

"We tried to create a model where we continuously operate profitably, even as the Big Three car makers from Detroit send their manufacturing jobs south of the border to Mexico," says one executive involved in devising the model.

By January, Tupelo had emerged as the front-runner for the new plant location. But at a meeting in mid-January, Messrs. Okuda and Toyoda posed more questions. Among other things, they asked why Toyota planned to spend

\$1.3 billion to build a new vehicle-assembly plant when the yen's persistent weakness made Japan a much cheaper place to produce cars, according to senior executives and board members. The two former top executives wanted to know "whether we had a precise plan to make Tupelo profitable quickly,"

according to one senior executive who was present in the meeting. "And we didn't have the answer."

After a detailed financial review, Toyota decided to scale back the Tupelo project. Instead of building 200,000 Highlanders a year, the new plant will produce 150,000. It will open in 2010 instead of 2009, and will employ about 2,000.

Inside Toyota, management-board members say, the scaled-back Mississippi project sent a message: no more new vehicle-assembly plants until production capacity is used up at existing ones. If North American demand for Toyotas continues to climb, the company can increase manufacturing capacity by adding second assembly lines at existing plants rather than by building new ones.

Now in jeopardy, these executives say, is a plan Toyota had been exploring to produce subcompact cars like the Toyota Yaris in Mexico rather than to import them from Japan.

Mitsuo Kinoshita, a Toyota executive vice president, says the company could produce the Yaris at existing plants in Ontario or in Brazil. "It's a complete blank sheet of paper right now," he says. Write to Norihiko Shirouzu at norihiko.shirouzu@wsj.com

