CORPORATE STRATEGY

by Michael Smitka

Toyota and 'Japanese management'

Behind the recall

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How could Toyota have gotten itself into such trouble? It carried scientific management to a new level with the just-in-time system. It made its name on quality, advertising that a worker could stop the assembly line to prevent any defects. Yet it is now subject to Congressional charges that it deliberately covered up flaws. Is the problem Japanese management? Is it specific to Toyota? Or is it the arrogance of big, successful firms?

I believe there are deep problems at Toyota, of which the safety recalls are just one manifestation. Their root is Toyota's strategy and structure as a large, rapidly growing firm.

Strategic disarray

The Toyota of today grew out of crisis 60 years ago. When the "Dodge Line" recession hit in 1949, Toyota continued to churn out vehicles that couldn't be sold, and found itself on the verge of bankruptcy. A government bailout in 1950 kept the company afloat, but the founding Toyoda family was forced out of senior management; it was only in 1967 that another family member, Eiichi Toyoda, became president. In addition, Toyota's marketing arm was split off from manufacturing, so that the factory would never again be able to force its sales operation to take unwanted vehicles. Competition was fierce—there were 30 Japanese car companies—and there was a clear awareness that relative to imports, Toyota was high in cost, backward in technology and abysmal in quality. The engineering side under Taiichi Ohno strove to overcome those deficits, giving birth to the Toyota Production System (TPS).

However, a car company can't thrive on lower costs and higher quality alone; it also needs attractive products and a strong marketing presence. The key to success lay with the first Toyota Sales president, Shotaro Kamiya, who shifted from General Motors (GM) to Toyota in 1935 and was the genius behind Toyota's eventual dominance of its home market, using a product differentiation strategy modeled after Alfred Sloan's GM. In cost and quality it was competitive, since foreign cars were limited by import quotas as late as the mid-1960s. In marketing it was superlative, leading to its GM-like 40% domestic market share.

Dominant firm marketing

Toyota's very success became its Achilles Heel. It flooded the market with dealerships, brands and models, drawing on its engineering prowess in developing vehicles quickly and cheaply. Like GM, it offered a car in every segment and a car for every pocket and demographic niche. Today it has six "channels" (dealership networks) in Japan, including that of its wholly-owned Daihatsu subsidiary; together they sell a chaotic and heavily overlapping mix of nearly 100 different car and truck models. (Post-bankruptcy GM, still the US market leader, is down to 40 models across four brands.)

Its customer base is also aging, hindered by conservative styling: sharp design was more likely to alienate current owners and cannibalize sales from other models than win new converts. Worse, many urban dealerships are company-owned stores that survive only through costly indirect subsidies. And the domestic market is barely profitable as Japan's ongoing demographic shift means the number of licensed drivers is now falling. To make matters worse, it also has an array of other ventures, including heavy trucks (Hino and Isuzu), boats, and prefab housing. It needs to carry out GM-like reforms at home, slashing brands and models and selling off non-core operations.

Management failed to evolve in line with its global expansion. Until 1992, when it opened plants in Kyushu and Iwate, core factories were all within driving distance of Toyota City headquarters outside Nagoya. Overseas, it was timid, entering the US indirectly in 1984 via its NUMMI joint venture with GM in California (now slated to be shuttered). By that time, Nissan and Honda had their own plants. Overseas management also reflects the historic split between sales (with headquarters in California) and manufacturing (with headquarters in Kentucky), while engineering is located in Michigan, and its lobbying and regulatory arm in Washington, DC. All report separately to their respective headquarters in Japan—sales in Nagoya, manufacturing in Toyota City and government relations in Tokyo. This is a recipe for the mixed signals and slow response we've observed with recalls, with reports of infighting between its US and Japanese arms.

Large-firm ills

Toyota's management was parochial in another sense: it thought of itself as a small engineering operation, run on the basis of "genchi, genbutsu" hands-on, bottom-up management. With 320,000 employees, 27 domestic plants and 53 overseas factories, that no longer works well. Toyota could have set up regional operations and delegated responsibility, as Ford and GM did in Europe and elsewhere. Instead Toyota kept power in Japan and shifted towards headquarters-based professional managers.

Under President Katsuaki Watanabe and EVP Mitsuo Kinoshita, both of whom announced their retirement in early 2009, the firm set ambitious goals, summarized in the earlier 2002 "Global Vision 2010." This aimed to take the firm from its 2000 level of six million units to global primacy with 10 million units. That meant hell-bent expansion that it proved unable to manage

In the US, the source of the majority of its global profits, further growth required expanding into new segments, including full-sized pickup trucks—such as the V-8 Tundra. Rather than building capacity in line with actual sales, it added new plants according to the Global Vision, including the Tundra plant in Texas, a second factory in Ontario, a new plant in Mississippi, and the purchase of Isuzu's US assembly line.

But while Toyota achieved its capacity goal, they failed on the sales front. Its Tundra plant has been closed for months at a stretch and the Mississippi plant remains half-completed. Meanwhile, the focus on larger vehicles left it lagging in China and a minor player in Brazil and India.

In 2009 Toyota was back at 6 million units of sales but with 10 million units of capacity. Only part of this could be blamed on the recession.

Meanwhile, Toyota mishandled foreign exchange risk. From just over a third of production in 1997, exports edged up to two-thirds of Toyota's Japan-based output at the end of 2008. That made the firm vulnerable as the yen appreciated by 25% from ¥120 per dollar in 2007 to the ¥90 level of early 2010. This was in part due to robust sales; the company was straining to meet demand. But it still represented a big bet that the yen would remain weak.

Furthermore, in 1982 Toyota Motors merged with its sales arm. Ironically, it has now repeated the mistake that led it to near-failure 60 years earlier. When sales US sales plummeted in fall 2008 it was slow to cut Japan-based production, leaving it with acres of cars in Long Beach, California and forcing temporary shut-downs in Japan.

Finally, it pushed its engineers to the limit. While Toyota hired lots of new graduates, it could not accelerate their learning curve: the pace of expansion truncated the apprenticeship of young engineers. That likely contributed to a gradual increase in quality problems—new president Akio Toyoda himself has claimed as much.

The "prince" takes charge

These problems came to a head in November 2008, when it became apparent that Toyota would be forced to declare a loss, representing a breathtaking ¥2.4 trillion ($26 bil.) swing in earnings in a single year. The elder Shoichiro Toyoda— the son of Toyota's founder, president during 1982-92 and now "honorary chairman"—stepped forth to criticize reigning executives, and in January 2009 his son Akio Toyoda was designated as Watanabe's successor to the presidency. Three other top executives announced their retirement soon thereafter.

Akio has a good pedigree. He worked briefly as an investment banker following his MBA from Babson College. In his spare time he races, marking him as a certified car guy. Within Toyota he was behind the firm's initial internet foray (gazoo.com) and continued to blog until recently; he was a vocal supporter of the Scion line of cars, designed to capture a younger demographic; he had headed the NUMMI factory in California; and as a young board member his portfolio included China. He has surrounded himself with a group of operating managers in their 40s, in a conscious attempt to return the company to its close-to-the-knitting roots. Along with speaking to continuing quality issues—Toyota lost its automatic seal-of-approval from *Consumer Reports* in 2008—he pushed for a consolidated management structure in the US with the implicit transfer of authority that would represent.

However, his post was not due to control by the founding family, but rather to the personal clout of his father at a time when management was deeply divided. What Akio proposes is sensible, but he may prove too mild of manner; I believe Toyoda will need to find a strong successor, perhaps from outside the company, just as Bill Ford did when he turned the reins over to Alan Mulally.

Implications for the Auto Industry

For the industry, the current crisis comes at an inopportune time. Sales remain depressed in the US, Japan and Europe; Toyota's fumbling of recalls may lead to additional regulatory constraints for all. Worse, it could push every firm operating in the US into legal quicksand, as lawyers turn unintended acceleration into a litigation gold mine.

Toyota will face tremendous pressure to increase volume. In February 2010 Toyota's US sales fell 8.7% from a year earlier when even Chrysler eked out a gain. Toyota has already boosted incentives—lowered its prices—undermining efforts by other firms to hold to their target pricing.

Toyota's problems impose an additional strain on American parts suppliers, which account for three factory jobs for each one at a final assembler. It also hurts dealerships, which account for as many jobs as all of manufacturing combined. These suppliers and dealers groups service the rest of the industry, so their struggles hurt everyone, not just Toyota.

Implications for Japan

It's an exaggeration to claim that Japan is suffering from a "Toyota recession"—but not by much. Autos and auto parts exports to the US accounted for 5.9% of Japan's global exports as recently as November 2008. Such exports then fell off a cliff, dropping from an average of ¥550 billion ($6.1 bil.) a month during the US bubble to ¥112 billion in January 2009, one-fifth of their earlier peak. If similar downturns in other markets are included, back-of-the-envelope calculations suggest that was enough to shave a full 1% off of Japan's GDP, with Toyota accounting for over half of that.

Toyota's problems are likewise disastrous for local government. Aichi Prefecture is in crisis: one-fourth of its budget stemmed from corporate income taxes. With profits zero or negative, tax receipts are zero. Meanwhile Toyota has shed its 11,000 contract workers; suppliers have sent their Brazilian workers "home" at government expense. The US bubble didn't affect Japanese financial institutions, but people in the Nagoya area clearly feel the US recession.

Japanese Management

Maybe we will at last see the legend of "Japanese Management" put to rest. It was always part myth, based on a small number of companies in what was always a large and diversified economy. Furthermore, that fad was driven by angst in the US more than by anything in Japan. Innovative managers in the Japan's early postwar years cast themselves as proponents of American management; likewise a mini industry of consultants and progressive managers did the same on the other side of the Pacific when Japan was perceived as Number One. Some of what they "sold" had little to do with Japan—which didn't mean that they offered bad advice. And some was genuinely revolutionary: the Toyota Production System (TPS) revitalized industrial engineering. Of course Ford and others hired such consultants, but the impact extends far beyond the automotive industry. Michael Dell read Ohno's book on production technology and utilizes Toyota's methods in his plants. Consumers across the globe benefit from TPS. However, such methods are less useful and harder to apply the further one moves from the shop floor.

Now we see a counter-reaction: Japanese governance is clearly inadequate, and …the list goes on. I would be glad to see a critical eye cast upon management fads. Toyota's factories, however, remain models of good practice. It would be unfortunate to see the TPS "baby" poured out with the bath water of Toyota's poor strategic management and Japan's bad macroeconomic performance.