

Chrysler February 17 Plan
Viability Determination

Summary

The Loan and Security Agreement of December 31, 2008 between Chrysler, LLC and the United States Department of the Treasury (“LSA”) laid out various conditions that needed to be met by March 31, including the approval of Labor Modifications, VEBA Modifications, and the commencement of a Debt Exchange (all as defined in the LSA).

As of the date of this memo, the above steps have not been completed, nor are they expected to be completed by March 31. As a result, Chrysler has not satisfied the terms of its loan agreement. Additionally, after substantial effort and review, the President’s Designee¹ has concluded that the Chrysler plan is not likely to lead to viability on a standalone basis, and that Chrysler must seek a partner in order to achieve the scale and other important attributes it needs to be successful in the global automotive industry while Chrysler operates under an amendment to the existing LSA.

This determination of viability was based on a thorough review, as conducted by the Task Force and its outside advisors and as summarized below, of the Company’s submitted plan and prospects. While there were many individual considerations, no single factor was critical to the assessment. Rather, the ultimate determination of viability was based upon a total consideration of all relevant factors, taken as a whole.

The Plan that was submitted by Chrysler on February 17, 2009 reflects some progress that has been made under current management but ultimately is insufficient due to several structural issues that Chrysler, as a standalone entity, is highly unlikely to overcome. In particular, Chrysler’s limited scale in an increasingly capital-intensive global business, the inferior quality of its existing product portfolio and its heavy truck mix leave the Company poorly positioned. Chrysler’s plan to address these issues is based on overly optimistic assumptions that are inconsistent with its current products and its resources. A few key challenges:

- **Scale:** Chrysler cannot afford to dedicate enough R&D to each product platform to maintain competitiveness, suffers from having a smaller supply purchasing base and amortizes its significant fixed costs over a much smaller base of vehicles than its competitors
- **Quality:** While the Company is committed to improving quality, its current quality scores significantly lag competitors. Chrysler admits that improving quality and associated brand perception will take a number of years.
- **Product Mix:** Chrysler does not have a product pipeline to cover the smaller car segments which are projected to grow in share of the overall car market and will struggle to meet proposed fuel-efficiency standards.
- **Manufacturing:** In contrast to best-in-class OEMs, as well as both GM and Ford, Chrysler has not invested significantly in common architectures and flexible plant manufacturing capacity, which will be critical to long-term profitability.
- **Geographic Concentration:** Unlike many of its competitors, Chrysler’s business is heavily weighted to North America, which makes the Company more vulnerable to local economic fluctuations and less able to take advantage of developing markets.

While the Company has made meaningful changes to its cost structure in the last few years, the combination of a fundamentally disadvantaged operating structure and a limited set of desirable products make standalone viability for the business highly challenging. As a result, the President’s Designee has found that Chrysler’s plan is not viable as currently structured. However, to the extent Chrysler can develop a partner who would improve Chrysler’s scale, bolster its product development, and allow it to enter the small car market with a robust set of products, Chrysler has some prospects for long term viability.

Detailed Determination

The Loan and Security Agreement of December 31, 2008 between the Chrysler Corporation and the United States Department of the Treasury (“LSA”) laid out various conditions that needed to be met by March 31, including:

- (a) Approval of the Labor Modifications (Compensation Reductions, the Severance Rationalization and the Work Rule Modifications) by the members of the Unions;
- (b) Receipt of all necessary approvals of the VEBA Modifications other than regulatory and judicial approvals; provided, that the Borrower must have filed and be diligently prosecuting applications for any necessary regulatory and judicial approvals; and
- (c) The commencement of an exchange offer to implement a Debt Exchange.

As of the date of this memo, the above steps have not been completed. As a result, Chrysler has not satisfied the terms of its loan agreement.

The LSA also requires that the President’s Designee review the Restructuring Plan Report in order to determine whether Chrysler has taken all necessary steps to achieve and sustain the long-term viability, international competitiveness and energy efficiency of the Company and its subsidiaries

Since receiving the Company’s plan on February 17th, the Government has engaged in substantial efforts to assess its viability. This work has involved staff from the Department of Treasury, National Economic Council, Council of Economic Advisors as well as the numerous other Cabinet agencies involved in the President’s Task Force on the Auto Industry. The working group has also worked extensively with several dozen individuals at industry-leading consulting, financial advisory and law firms. Numerous outside experts and affected stakeholders have been consulted. Based on this work, the President’s Designee has concluded that the Chrysler plan is not likely to lead to viability on a standalone basis, and that Chrysler must seek a partner in order to achieve the scale and other important attributes it needs to be successful in the global automotive industry.

While the President’s Designee considered many factors when assessing viability, the most fundamental benchmark was the following: for a business to be viable, it must be able – after accounting for spending on research and development and capital expenditures necessary to maintain and enhance the company’s competitive position -- to generate positive cashflow and earn an adequate return on capital over the course of a normal business cycle.

The Plan that was submitted by Chrysler on February 17, 2009 reflects some progress that has been made under current management but ultimately is insufficient due to several structural issues that Chrysler, as a standalone entity, is highly unlikely to overcome:

Progress to date:

- Chrysler has made meaningful progress, and identified a great deal more opportunity, in reducing its cost structure as part of a major operating restructuring:
 - **Structural costs:** The Company plans to reduce structural costs by 29% from 2007 to 2009. These improvements are driven largely by aggressive reductions in salaried headcount, which is expected to fall by 60% from 2000 to 2010.

- **Capacity utilization:** The plan contemplates the reduction of manufacturing capacity by 1.3M units in order to respond to a depressed global auto market. The manufacturing capacity will be eliminated mainly through the closure of two assembly plants and five engine plants from 2009 to 2014.
- **Wage rate rationalization:** The Company projects that its US hourly wage rate will reach benchmark levels by 2010. These assumptions are based on current negotiations, which have yet to be finalized.
- Chrysler's plan also focuses on improving product quality, which has historically lagged at Chrysler:
 - Since the formation of Chrysler LLC, there has been a renewed effort to increase the quality and interior content of vehicles, although quality often takes many years to significantly improve and the perception of quality can lag still further. Importantly, current market research by independent experts does not suggest any significant improvement in customers' perception of Chrysler product quality.

In short, Chrysler's current management team has made meaningful progress in addressing the areas under which they have the most control, particularly on a short-term basis. However, Chrysler suffers from a number of structural disadvantages that can not be addressed on a standalone basis. In particular, Chrysler's limited scale in an increasingly capital-intensive global business, the poor quality of its existing product portfolio and its heavy truck mix leave the Company poorly positioned. Chrysler's plan to address these issues is based on overly optimistic assumptions that are inconsistent with its current products and its resources.

- Chrysler's smaller scale has broad implications for its business, both at the top line as it seeks necessary improvements in its product portfolio and at the bottom line as it seeks to improve its cost structure.
 - **Product Development:** Chrysler's scale limits its product development budget overall, and particularly limits the amount the Company can spend developing each platform. Chrysler currently dedicates only 50% as many engineers to each platform, on average, as GM does. Furthermore, Chrysler has much lower volume platforms, on average, than most of its competitors, and these lower volume platforms mean that Chrysler must amortize its R&D and capital expenditures over a much smaller base. This, of course, limits the Company's ability to innovate and develop new product.
 - **Purchasing:** Due to its limited scale, the Company is unable to exert leverage on suppliers to reduce its cost of goods. For example, GM's average yearly global buy is ~\$90B, whereas Chrysler's is ~\$20B.
 - **Fixed costs:** Chrysler's more limited scale means that some of its fixed costs are spread over a smaller base. As a result, Chrysler has a significant disadvantage on fixed costs (estimated at approximately 3-4% of revenue), which translates into several hundred dollars per car of reduced profit.
- Chrysler's products have also historically underperformed in terms of quality, which remains a significant challenge:
 - **Quality Ratings:** Chrysler has low quality scores across all of its brands, and perceived quality lags the best-in-class OEMs (2008 IQS of 147 for Chrysler versus 105 for Toyota). Moreover, every single one of Chrysler's brands are in the bottom quartile based on JD Power APEAL scores. Finally, a recent Consumer Reports article listed Chrysler last in terms of the number of recommended nameplates in its portfolio (zero Chrysler nameplates were recommended). By contrast, all of GM's continuing brands outperform Chrysler on an IQS basis and, on average, substantially outperform on APEAL scores.
 - **Timeframe:** While there has been a renewed focus on quality since January 2008, Chrysler admits that improving quality and associated brand perception will take a number of years, as about 40% of quality issues (IQS/100 vehicles) are design related and are typically not addressed until a new product is developed.

- The Company is burdened with an unfavorable product mix, which may create further disadvantage in the evolving marketplace:
 - **Market tastes and shifts:** Chrysler does not have a product pipeline to cover the smaller car segments which are projected to grow in share of the overall car market. Chrysler's shares of the small and medium car markets are 3% and 7%, respectively (while each category represents 21% and 25% of the market, respectively), and has been declining in each segment.
 - **Current focus:** In the near term, Chrysler is planning to lift profitability by focusing on its more profitable truck and SUV segments. Given the potential variability in fuel prices, Chrysler's volume assumptions for these cars may be at risk.
 - **CAFE standards:** Chrysler's product strength is in the pickup, SUV, and minivan segments – all of which are relatively low in fuel efficiency. On a standalone basis, Chrysler will struggle to comply with increasing fuel efficiency standards, and it may even have to restrict the sale of certain models to make sure it is in accordance with proposed standards.

The limitations imposed on Chrysler by its smaller scale permeate its ability to manage its business and hinder its hopes of improving its fortunes. For example:

- Given Chrysler's limited financial resources, it can not make the necessary catch-up investments in R&D required to refresh its portfolio and bring it up to par with its competitors. So, while Chrysler's declining competitive position demands that it makes substantial investments in new products and a more diversified mix of products, its own plan projects the following:
 - **Limited new products:** The 2009 through 2014 product plan delivers only four new nameplates under the current Chrysler umbrella, with potential for additional nameplates only through a partnership.
 - **Powertrain development:** While Chrysler is investing in newer powertrain development, as are all the OEMs, its limited resources lead it to project spending just over 3% of revenue on R&D over the next five years, versus 4-5% for General Motors, Toyota and Honda.
 - **Small cars:** Chrysler's standalone plan does not provide for a substantial entrance into the small car segments – an area that will be increasingly important to automotive manufacturer profitability if potential gasoline price hikes meaningfully increase demand for smaller, more fuel-efficient cars and as CAFE standards demand a higher mix of small cars.
- Chrysler also lags its competitors in terms of manufacturing flexibility:
 - Virtually all industry observers and outside experts agree that increasing flexibility in the manufacturing footprint is critical to driving long-term profitability in the global automotive industry. In contrast to other best-in-class OEMs, as well as both GM and Ford, Chrysler has not invested significantly in common architectures and flexible plant manufacturing capacity to build multiple platforms in a given plant.
 - Chrysler is planning to invest in more flexible capacity but is behind both the transplants and GM in this capability. This lag increases Chrysler's risk to market segment shifts and individual product acceptance. For example, of the nine plants Chrysler is targeting to have by 2013, only two will be flexible across multiple platforms (compared to ~80% of GM plants).

Given these substantial obstacles, the assumptions in Chrysler's business plan are too aggressive:

- **Market share:** Chrysler's plan assumes that it maintains its current market share, although the Company has consistently lost share over the last decade

- Chrysler has lost five percentage points of market share since the height of its share, at 16.2%, in 1998. This loss has occurred across all segments, even within its historically strong minivan offerings, where share has declined from 39% to 33% since 2006.
- The plan projects market share to stabilize at 10.7% and assumes that Chrysler will be able to find partnerships to launch new products in a very competitive market. Continued share erosion in line with recent history would translate into several billion dollars of increased losses over time.
- Unlike GM, which has had a number of successful recent product introductions and has developed a new global product development process that has promise, there are few tangible signs that Chrysler can reverse its share erosion. In fact, the gap in perceived brand quality for Chrysler, Dodge and Jeep relative to their competitors has increased meaningfully over the last several years, suggesting that Chrysler's market share, if not for significantly increased incentives that have further eroded profitability, is even more vulnerable than history suggests.
- **Financing:** The viability plan relies on Chrysler's captive financing arm to provide a significant amount of financing, which may prove challenging:
 - In general, Chrysler's customer mix is skewed to a lower FICO score buyer (in the first quarter of 2008, approximately 34% of buyers were subprime or near-subprime), so the current financing environment disproportionately hurts traditional Chrysler buyers' ability to purchase a new car.
 - Given the separation and independence of Chrysler Financial and increased credit standards, it is unlikely that demand will return to the robust levels of recent years in the near term.
 - In 2008, 48% of financing for Chrysler buyers was provided by Chrysler Financial. The captive finance unit has substantial financing challenges of its own in the current financing environment, so future demand may depend on Chrysler finding alternate lending sources.
- **Price realization:** Chrysler also assumes only a modest decline in price realization despite entering highly competitive segments:
 - Given the quality gap from which Chrysler suffers, it will be challenging to maintain pricing as projected.
 - Even more importantly, the Company projects providing lower incentives than it has provided in its recent history – at a level of more than 25% less than the recent historical average. If the incentives were “normalized”, based on the average of 2006 - 2007 incentives, the Company will lose consistently between \$500 million and \$1 billion per year from 2010 to 2014 on an EBIT basis. This is inconsistent with the Company's recent history with regard to incentives, in which increasingly larger incentives still translated into continued share erosion.
- **Variable margin:** The plan also includes a constant variable margin assumption, despite a shift to producing lower margin vehicles. The primary drivers of this assumption are improved price realization and a reduction in cost of goods fueled by material cost management and supplier concessions of 3%, which may prove difficult given Chrysler's limited scale and distressed supply base.

While the Company has made meaningful changes to its cost structure in the last few years, the combination of a fundamentally disadvantaged operating structure and a limited set of desirable products make standalone viability for the business highly challenging. As a result, the President's Designee has found that Chrysler's plan is not viable as currently structured. However, a partnership with another automotive company, such as Fiat or another prospective partner, which addresses many of these issues could lead to a path to viability for Chrysler.