

HYUNDAI'S Toyota Obsession

The South Korean automaker has come a long way from making small cars whose engines blew up and bodies rusted. It's poised to take on its Japanese rival.

By John Lippert and Yunsuk Lim

◀ To get to Hyundai Motor Co.'s research center in Namyang, 30 miles (48 kilometers) southwest of Seoul, you drive past long stretches of rain-swollen rice paddies and concrete-block shacks. Those images of South Korea's impoverished past fade when you reach the center, a gleaming complex filled with wind tunnels, crash-test tracks, clay-model design studios and prototype assembly plants. The center employs 7,070 people, including a thousand who have doctorates or master's degrees, and most of them work 12 hours a day—at least. While the center used to provide three free hot meals daily, Hyundai officials stopped serving dinner on Wednesday

nights to encourage the company's researchers to spend time with their families. The plan failed. So many employees went out to dinner and then returned to their desks that the center may resume the Wednesday supper service.

That brand of fervor has helped elevate Seoul-based Hyundai from an exporter of low-quality vehicles to an automaker poised to compete with U.S., Japanese and European rivals in all major markets, says Ron Harbour, president of Harbour Consulting Inc., a manufacturing research firm in Troy, Michigan. Chairman Chung Mong Koo, 67, says he wants the capacity to build 5.5 million vehicles annually by



Hyundai Chairman **Chung Mong Koo** says he wants the capacity to build 5.5 million vehicles a year by 2007, up from 4 million now.



2007, up from 4 million now. He also says he wants overseas output to increase to 45 percent of Hyundai's total by 2007 from 20 percent now.

Chief Executive Officer Kim Dong Jin says he expects Hyundai Auto Group, which includes Kia Motors Corp., to be ranked among the world's five-largest automakers as soon as 2009, passing Volkswagen AG and DaimlerChrysler AG. "If it took the Japanese 30 years to evolve into globally dominant automakers, the Koreans are trying to do it in half the time," Harbour says. "They can do it, but there will be some ups and downs along the way."

Some of the bumps were apparent in the first quarter of this year, when Hyundai's pre-tax operating profit fell 30 percent to 322.7 billion won (\$311.6 million) as sales slumped 0.6 percent to 6.17 trillion won. The company's stock rose 13.7 percent this year through July 12 to 63,100 won compared with a 16.8 percent rise in the benchmark Kospi index.

The stock has room to move up, says Wendy Trevisani, who manages 999,720 Hyundai Motor shares at Thornburg Investment Management Inc. in Santa Fe, New Mexico. "We think management is solid, with the ability to improve brand equity, yet the valuation hasn't reflected the recent improvements,"



The company's facility in Ulsan, South Korea, is the world's largest automotive manufacturing complex, turning out 1.6 million vehicles annually and shipping 60 percent of them directly overseas.

as chairman of Hyundai Motor, Chung Ju Yung kept his eye on daily production. He was known as "the Tiger" among his employees because of his surprise inspections at Hyundai work sites. He would show up even in the middle of the night to rouse and question employees.

Chung Ju Yung based Hyundai's manufacturing operation in Ulsan, a former fishing village on what Koreans call the East Sea and what the Japanese call the Sea of Japan. Today, the company's dock at Ulsan is surrounded by a tangle of blue buildings that make up the largest automotive manufacturing complex in the world, with five assembly plants, seven engine factories and 34,000 workers. The Ulsan complex can make 1.6 million vehicles annually; 60 percent are sent directly to the dock for shipment overseas.

The company, with Chung Se Yung at the helm, made its first foray into the U.S. market in 1986, exporting \$6,000 Excel subcompacts. Chung Se Yung opened a factory in Bromont, Quebec, in 1989, which turned out Excels that were plagued by engines that blew up too often and sheet metal body panels that rusted out too fast. By 1994, Chung Se Yung had closed the Bromont factory after finishing last in an annual study of initial quality by Westlake Village, California-based J.D. Power & Associates. In 1998, Hyundai Motor sold 90,217 vehicles in the U.S. compared with 1.4 million for Toyota Motor Corp.

Hyundai must now hold off resurgent domestic competitors such as GM Daewoo and Renault Samsung.

The next year, Chung Ju Yung ousted Chung Se Yung as Hyundai's chairman after 32 years in the job. The move came partly because the younger brother opposed Chung Mong Koo's plan to buy bankrupt Kia, South Korea's second-largest automaker, and to use combined profits to finance an overseas expansion, says Don Southerton, who owns Bridging Culture, a Vista, California-based consulting firm with clients that include Hyundai Motor.

The family drama continued in 2000. As Chung Ju Yung lay dying, two of his five sons fought over a business empire that included the world's largest shipyard, the world's second-biggest memory chip manufacturer and South Korea's biggest auto company, Hyundai. At first, it seemed Mong Koo, the oldest son, would be the loser. Chung Ju Yung bequeathed control of the bulk of his sprawling Hyundai conglomerate to Mong Hun, the fifth in line. Mong Koo was left with just one business, Hyundai Motor.

In just a few years, the two brothers' fates diverged. Mong Hun leapt to his death at Hyundai's Seoul headquarters in 2003 after being charged with illegally funneling money to North Korea. Mong Koo has steered Hyundai Motor so well that he's now the country's second-richest equity investor, with 1.33 trillion won in holdings, according to the Korea Stock

she says. Hyundai Motor sold for 8.05 times estimated 2005 earnings on July 12 compared with an average of 12.05 times for companies in the Bloomberg World Auto Manufacturers Index.

Hyundai was founded in 1967 by Chung Mong Koo's father, Chung Ju Yung, who rose from poverty in the farming town of Tongchon in what's now North Korea to become the billionaire owner of his nation's largest industrial empire. Though he appointed his younger brother, Chung Se Yung,

Exchange. Lee Kun Hee, 63, chairman of Samsung Electronics Co., ranks first, with 1.38 trillion won.

Hyundai Motor's road to global prominence still has some potholes. The company benefited when the won slumped against the U.S. dollar during the 1990s Asian financial crisis. In 1999, Hyundai could export a car to the U.S. with the equivalent of \$12 in hourly wage costs, or half as much as General Motors Corp., says Kim Hag Ju, an analyst at Samsung Securities Co. in Seoul. Chung Mong Koo can't count on this tailwind any longer. The won rose

9.8 percent against the dollar in the 12 months ended on July 12. He also faces the resurgence of domestic competitors such as Inchon-based GM Daewoo Auto & Technology Co. and Busan-based Renault Samsung Motors Co. Mumbai-based Tata Motors Ltd., India's biggest truckmaker, may export cars to South Korea soon, says Ravi Kant, executive director for commercial vehicles.

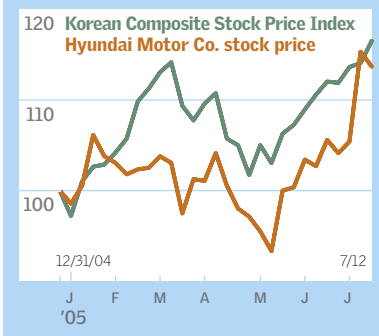
Another worry is South Korea's credit card binge. One in 13 of South Korea's 48 million people was behind in his or her debt payments by at least three months at the end of 2004, government data showed. This debt forced people to cut back on buying cars, and industrywide sales dropped 17 percent in 2004 to 1.09 million vehicles and another 4.7 percent this year through May.

Investors should also be concerned about 13.8 trillion won in debt spread through dozens of companies now controlled by Chung Mong Koo, not just 1.8 trillion won in debt at the motor company, says Eun Jin Kim, a Standard & Poor's analyst. Kim has a junk rating on the automaker's debt. He says the rating could deteriorate further because INI Steel Co., South Korea's second-largest steelmaker, said in May that it planned to build two blast furnaces. Chung holds an 11.7 percent stake in INI Steel; Kia holds 19.9 percent.

Even so, Hyundai retains the ability to outwork its competitors, says Kazuo Ishikawa, executive vice president of Central Motor Wheel of America Inc. in Paris, Kentucky. "In Japan and the U.S., when people get to a certain level, when they get rich, they start getting lazy," says Ishikawa, whose company makes wheels for Hyundai Motor's plant in Montgomery, Alabama, and Toyota's factory in Georgetown, Kentucky. "The Koreans and the Chinese, they're still hungry."

At GM Daewoo Auto in Inchon, CEO Nick Reilly, 55, who joined that company

Bouncing back Hyundai's shares began to catch up to the Kospi in May, as South Korea's currency weakened.



Index: Dec. 31, 2004 = 100. Source: Bloomberg

from Vauxhall Motors Holdings Ltd., estimates his engineers are 20 percent more productive than and work for half the pay of GM engineers in Detroit. The same is true at Namyang.

Peter Butterfield, 52, a U.S. native and CEO of Kia's U.S. sales unit, says this productivity is a manifestation of Confucian beliefs about hierarchy and respect for elders that he says are stronger in South Korea than anywhere else. The main impact is speed.

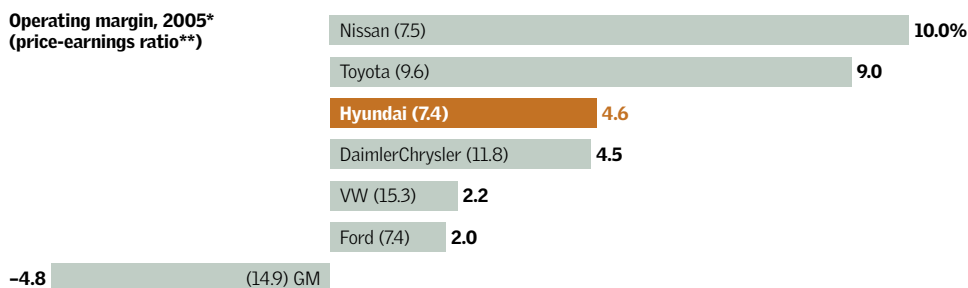
Butterfield says that soon after he joined the company in November 2001, his Korean supervisor asked whether they

should move up to August a scheduled redesign of Kia's Optima sedan. Butterfield remembers asking, "You mean August 2003, right?" The supervisor replied, "No, I mean August 2002." Butterfield says his former employer, Ford Motor Co., would have spent months writing 500-page research papers before making this decision.

The Beijing airport is a good place to measure how fast Chung Mung Koo is moving. A string of 50 construction cranes lines a field across from the main airport building; they're part of an effort to build a new terminal for visitors to the 2008 Summer Olympics. Taxis from Hyundai Motor are one element of the Chinese government's effort to present an upbeat image during the Olympics. The yellow-and-green Elantra compacts from Hyundai Motor present a trim and contemporary contrast to the red Charade subcompacts that Tianjin FAW Xiali Automobile Co. started selling as taxis in Beijing 20 years ago. Beijing residents can sometimes be seen waiting as Charade taxis pass by, hoping for an Elantra.

Hyundai Motor opened a joint-venture factory with the Beijing government 3 miles north of the airport in 2002. The factory is surrounded by suppliers such as Hyundai Mobis Co., whose cockpit, suspension and front bumper modules make up 40 percent of the value of each car, General Manager Chun Yong Duk says. Hyundai Mobis workers, who are paid about \$300 a month, build the modules

Caution flag Hyundai Motor earns more than its U.S. and European competitors. Still, investors pay a lower premium for its projected 2006 earnings.



*First quarter. **Based on estimated 2006 earnings. Source: Merrill Lynch

on assembly lines with an expensive array of robots and computer-controlled test stations. The quality they help produce equals that of Hyundai Motor in South Korea, says Noh Jae Man, president of Beijing Hyundai Motor Co. Last year's 16 percent operating margin at Beijing Hyundai was the widest anywhere in Hyundai Motor. The margin, which shows the share of sales left after paying all business expenses, may narrow to as little as 10 percent this year as competitors cut prices, Noh says. To prevent that, he was trying to cut the labor needed to assemble each car by 17 percent, to 20 hours, from June to September.

Beijing Hyundai can make 300,000 cars annually at its existing plant; it's building a second factory nearby. Along with Kia, Hyundai aims to build 1 million vehicles annually in China by 2010, or one-fifth of its global output, Noh says.

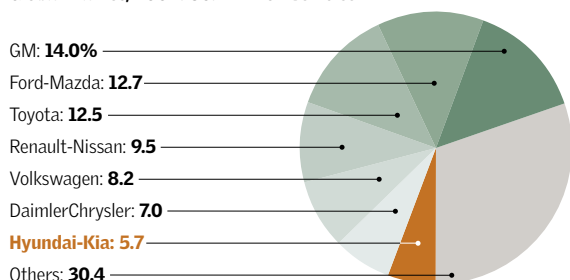
Chung Mung Koo is starting to sell Hyundais in Japan via Mitsubishi Motors Corp. dealerships. He's building a second factory in India, where Hyundai is the third-biggest automaker. He's building a 1.1 billion euro (\$1.3 billion) factory for Kia in Slovakia. "It's amazing how well Hyundai and Kia have been accepted by upper-income customers, even in places like Switzerland," says Christian Takushi, whose funds at Swissca Portfolio Management AG in Zurich hold 58,600 Hyundai Motor preferred shares and 31,636 common shares.

One advantage Hyundai Motor has in Switzerland is that nobody remembers burning engines and rusting body panels from the 1980s and '90s. That's not true in the U.S. Today, only 16 percent of U.S. car buyers will consider a Hyundai compared with 60 percent for Toyota, 46 percent for Honda Motor Co. and 33 percent for Nissan Motor Corp., according to John Krafcik, Hyundai's U.S. product development chief. To make matters worse, Toyota can charge \$20,697 for a typically equipped four-cylinder Camry compared with \$18,505 for a Hyundai Sonata, according to Edmunds.com, a Web site that compares automobile prices.

Since taking over Hyundai Motor five years ago, Chung has been obsessed with erasing Toyota's price premium. Every Monday morning in Seoul, he personally inspects new models and scolds his subordinates when he spots a defect. In a wood-paneled conference room on the ground floor of his Seoul headquarters, he posted a 6-foot-square board with advice he received from J.D. Power III himself in 1998. The advice, including the admonition that Hyundai Motor wasn't listening enough to customers, won't come down off the wall until Chung meets his goal of passing Toyota in quality. "They've not just been listening but very much following what

Thinking big Hyundai Motor says it can pass Volkswagen and DaimlerChrysler by 2009.

Global market, 2004: 60.9 million vehicles



Source: Global Insight

we said," J.D. Power III says.

After finishing last in the J.D. Power initial quality survey in 1994, Hyundai tied for 10th with GM's Hummer, with 110 customer complaints per 100 cars, in the 2005 survey; Honda finished 12th, with 112. Toyota's Lexus brand ranked first, with 81.

CEO Kim says Hyundai Motor now recognizes that volume won't lead to sustained

profits if it can't also charge premium prices. "Therefore, we changed the company slogan," Kim says. "We want to become the quality leader instead of a volume manufacturer."

To do it, Chung is hiring stylists who specialize in upscale sedans, including Tom Kearns, who designed the Cadillac CTS, and Joel Piaskowski, who designed the Buick Lucerne. Chung is also developing new products for the U.S., including a minivan, a Ford Explorer-size SUV and a rear-wheel-drive luxury sedan.

Changing the brand's reputation won't be easy, says Doug Scott, senior vice president at Gfk-Automotive, a marketing consulting firm in Nuremberg, Germany. Sales at Volkswagen's Audi unit plummeted after reports of unintended accelerations by its cars in 1985, and they didn't recover for 15 years, Scott says. "Even if Hyundai Motor keeps improving its initial quality and durability, I think it would be 2010 or 2015 until customers' perception of its quality risk relative to Toyota collapses down to zero," he says.

Hyundai Motor's damaged quality reputation in the U.S. is just one measure of how difficult globalization can be. Even Toyota, a company that in 2001 plastered the walls of its factories worldwide with an operating philosophy called "the Toyota Way," can't achieve uniform results, says James Womack, president of the Lean Enterprise Institute in Brookline, Massachusetts, a Boston suburb. Toyota's internal data indicate that its overseas plants, when measured in terms of quality, productivity and ability to introduce and build a variety of models on time, perform at 85-90 percent of the level of factories in Japan, Womack says. Dennis Cuneo, senior vice president of Toyota's North American unit, says that performance standards are highest in Japan. He declined to quantify the difference.

Hyundai Motor showcased its globalization campaign on May 20, when Chung dedicated the company's \$1.1 billion Montgomery assembly plant. Former President George H.W. Bush welcomed Hyundai Motor by reminding the 4,500 people gathered in a white tent next to the factory that South Korea is one of a handful of countries with soldiers fighting with the U.S. in Iraq. "This plant is only the latest manifestation of close ties between two great nations," Bush said.

Chung, who is so concerned about blending into Alabama

life that he ordered Koreans assigned to the plant to eat hamburgers in the cafeteria, not seasoned Korean vegetables called kimchi, seemed subdued when speaking about preparations to build the company's new Sonata sedan in Alabama. "It's been a long, tough three years," he told reporters. Hyundai started building Sonatas in Montgomery in May, two months later than planned. The Alabama factory is the most automated Hyundai Motor factory in the world, partly to compensate for the lack of industrial experience among its workers, says Samsung Securities' Kim Hag Ju.

Arriving steel is unloaded, stamped into metal body panels, stored in overhead conveyors and then welded into finished car bodies—all without being touched by human hands. Many different vendors built the machines. Sometimes, computer software had to be developed on the spot to make sure the machines communicated effectively, says John Kalson, director of production. Meanwhile, the entire assembly line stopped. Instead of building 150,000 Sonatas in 2005, the company now has a goal of 120,000, Kim says. Bob Cosmai, who runs Hyundai Motor's U.S. sales operation, says Sonata output may total 80,000 this year.

The company realizes that volume won't lead to increased profit unless it can charge premium prices.

The Alabama plant is so automated and uses so many modules from Hyundai Mobis that it's expected to employ 2,000 workers to make 300,000 vehicles annually. That's half as many people as Honda needed to build the same number of cars at its factory in Lincoln, Alabama. Those 2,000 Hyundai employees, many of them from dissimilar

work backgrounds, still need to find a way to blend together. Kalson came from a Ford factory that makes Mustangs in Flat Rock, Michigan. The superintendent of his final-assembly shop comes from Nissan; the stamping shop chief, from GM; the engine shop head, from DaimlerChrysler; and the paint shop boss, from Ford. "We get to pick and choose what works from these different systems," Kalson says. "As far as the cultural mind-set on how we do business, it's just kind of bred that way." That's why he sent hundreds of workers for training in South Korea, he says.

Kim is feeling the pressure. "As our companies are growing so fast, it's not easy to assign good managers, competent managers, to overseas plants," he says. On June 1, 11 days after the dedication in Alabama, Hyundai named Ahn Joo Soo as the plant's CEO, replacing Lee Moon Hee. The company shows no sign of slowing down. "When this plant becomes profitable, and when we have the need, the customers, we are going to build another plant," Kim says.

Hyundai Motor's manufacturing methods, with top-down control exercised through personal relationships more than through formal bureaucracies, are best suited for running



Hyundai's factory near Beijing in China has the company's highest operating margin. Hyundai Mobis workers assemble modules nearby.

high-volume factories with few model changes as in Ulsan, the Lean Enterprise Institute's Womack says. "The question remains: Can they put in a production system that gets them reasonable costs and high quality when they're faced with a strong won as opposed to a weak won, and when they're operating off shore as opposed to back home?" he says. "I'm not saying they can't, but they're certainly facing a higher degree of difficulty."

The person with the most to win or lose is Chung Mong Koo's son, Chung Eui Sun, 34. He's being groomed to take over the family business by serving as president of both Hyundai

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threatened to delay construction of the Kia plant in Slovakia, Bridging Culture's Southerton says. South Korea's Confucian heritage means investors won't know how capable Eui Sun is until he takes over, says Richard Steers, a management professor at the University of Oregon. "In Korea, nobody asks how the son is doing because it's offensive to the father," Steers says.

Mobis, South Korea's largest auto parts maker, and Kia, whose stock price soared 37.3 percent to 14,550 won this year through July 12 as it began sharing more new-model designs with Hyundai Motor. As an informal troubleshooter for his father, Eui Sun, who holds an MBA from the University of San Francisco, helped resolve a land dispute that

Seoul-based LG Electronics Inc., the world's fourth-largest mobile phone maker, is making South Korean history by reaching outside its founding family to allow CEO Kim Ssang Su, 60, to function as its most visible leader and spokesman. Some investors say Hyundai may also reach outside in search of management talent. "Someday, these companies will have the courage to appoint world-class managers, and that will make them stronger," says Henry Seggerman, CEO of New York-based International Investment Advisers, which owns 46,000 Hyundai Motor shares.

In any case, Chung Eui Sun won't have to fight over his father's deathbed to gain control. He's Chung Mong Koo's only son, so he's certain to be walking in the footsteps of a grandfather who left a farm to create one of Asia's great family dynasties and a father who thrust Hyundai Motor onto the global automaking stage. ▶

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BLOOMBERG TOOLS

Hyundai's Holders

To search for institutional investors and insiders whose trading might influence the price of Hyundai Motor shares, begin by typing 005380 KS <Equity> PHDC <Go>. Next, type 1 <Go> to display a list of holders sorted by the number of shares held. For example, Thornburg Investment Management, which was ranked 12th on the list as of July 12, owned 999,720 shares, or 0.457 percent of Hyundai Motor's shares outstanding, according to a March filing. Thornburg had purchased a net total of 333,250 shares since the previous filing date. Next, type PHDC2 <Go> to display the holders sorted alphabetically, PHDC3 <Go> to list insider holdings sorted by size.

You can create a custom holdings search that will rank holders by the number of shares purchased since the previous filing date by typing PHDC <Go> and clicking on the number of an undefined search option under the Custom Search Criteria heading. Enter a search title, such as *LARGE BUY*, in the NAME field, as shown at right. Then enter *C* in the REPORT SORT ORDER field to select Change in Size

of Holdings. Press <Go> to save the search, and type 98 <Go> to run it.

To create a similar search that ranks holders based on the number of shares sold since the previous filing period, type PHDC <Go> again and select another undefined search option. This time, enter *LARGE SELL* in the NAME field and enter *L* in the REPORT SORT ORDER field to select Change in Size of Holding (Sells First). Follow the same steps as in the previous example to save and run the search.

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To compare the return of Hyundai Motor common stock with the relative returns of its benchmark index and industry group, type 005380 KS <Equity> RG <Go>.