

Porsche changes tack

Finance



Porsche Changes Tack Yes, of course, we have heard of shareholder value. But that does not change the fact that we put customers first, then workers, then business partners, suppliers and dealers, and then shareholders. Dr. Wendelin Wiedeking, CEO, Porsche, *Die Zeit*, April 17, 2005. Porsche had always been different. Statements by Porsche leadership, like the one above, always made Veselina (Vesi) Dinova nervous about the company's attitude about creating shareholder value. The company was a paradox.

Porsche's attitudes and activities were like that of a family-owned firm, but it had succeeded in creating substantial shareholder value for more than a decade. Porsche's CEO, Dr. Wendelin Wiedeking, had been credited with clarity of purpose and sureness of execution. As one colleague described him: " He grew up PSD: poor, smart, and driven. " Porsche's management of two minds had created confusion in the marketplace as to which value proposition Porsche presented. Was Porsche continuing to develop an organizational focus on shareholder value, or was it returning to its more traditional German roots of stakeholder capitalism?

Simply put, was Porsche's leadership building value for all shareholders, including the controlling families, or was it pursuing family objectives at the expense of the shareholder? Vesi had to make a recommendation to her investment committee tomorrow, and the evidence was confusing at best. Shareholder Wealth or Stakeholder Capitalism? Vesi's dilemma was whether Porsche—Porsche's leadership—was increasingly pursuing shareholder wealth maximization or the more traditional Continental European model of stakeholder capitalism.

Shareholder Wealth Maximization. The Anglo-American markets—the United States and United Kingdom primarily—have followed the philosophy that a firm's objective should be shareholder wealth maximization. More specifically, the firm should strive to maximize the return to shareholders, as measured by the sum of capital gains and dividends. This philosophy is based on the assumption that stock markets are efficient; that is, the share price is always correct, and quickly incorporates all new information about expectations of return and risk.

Share prices, in turn, are deemed the best allocators of capital in the macro economy. Agency theory is the subject of how shareholders can motivate management to accept the prescriptions of shareholder wealth. For example, liberal use of stock options should encourage management to think like shareholders. If, however, management deviates too far from shareholder objectives, the company's board of directors is responsible for replacing them. In cases where the board is too weak or ingrown to take this action, the discipline of the equity markets could do it through a takeover.

This discipline is made possible by the one-share-one-vote rule that exists in most Anglo-American markets. Copyright © 2007 Thunderbird School of Global Management. All rights reserved. This case was prepared by Professor Michael H. Moffett for the purpose of classroom discussion only, and not to indicate either effective or ineffective management. Special thanks to Wesley Edens and Pilar Garcia-Heras, MBA '06, for case-writing assistance.

Stakeholder Capitalism. In the non-Anglo-American markets, particularly continental Europe, controlling shareholders also strive to maximize long-term returns to equity.

However, they are more constrained by powerful other stakeholders like creditors, labor unions, governments, and regional entities. In particular, labor unions are often much more powerful than in the Anglo-American markets. Governments often intervene more in the marketplace to protect important stakeholder interests in local communities, such as environmental protection and employment needs. Banks and other financial institutions often have cross-memberships on corporate boards, and as a result are frequently quite influential. This model has been labeled stakeholder capitalism.

Stakeholder capitalism does not assume that equity markets are either efficient or inefficient. Efficiency is not really critical because the firm's financial goals are not exclusively shareholder-oriented since they are constrained by the other stakeholders. In any case, stakeholder capitalism assumes that long-term “loyal” shareholders—typically, controlling shareholders—rather than the transient portfolio investor should influence corporate strategy. Although both philosophies have their strengths and weaknesses, two trends in recent years have led to an increasing focus on shareholder wealth.

First, as more of the non-Anglo-American markets have increasingly privatized their industries, the shareholder wealth focus is seemingly needed to attract international capital from outside investors, many of whom are from other countries. Second, and still quite controversial, many analysts believe that shareholder-based multinationals are increasingly dominating their global industry segments. Porsche AG I know exactly what I want and what must happen. I am the real one. You can be sure. Dr. Wendelin

Wiedeking Porsche AG was a publicly traded, closely held, German-based auto manufacturer.

Porsche's President and Chief Executive Officer, Dr. Wendelin Wiedeking, had returned the company to both status and profitability since taking over the company in 1993. Wiedeking's background was in production, and many had questioned whether he was the right man for the job. Immediately after taking over Porsche, he had killed the 928 and 968 model platforms to reduce complexity and cost, although at the time this left the company with only one platform, the 911. Wiedeking had then brought in a group of Japanese manufacturing consultants, in the Toyota tradition, who led the complete overhaul of the company's manufacturing processes. Wiedeking himself made news when he walked down the production line with a circular saw, cutting off the shelving which held parts. Porsche had closed the 2004/05 fiscal year (ending July 2005) with €6.7 billion in sales and €721 million in profit after-tax. Wiedeking and his team were credited with the wholesale turnaround of the specialty manufacturer. Strategically, the leadership team had now expanded the company's business line to reduce its dependence on the luxury sports car market, historically an extremely cyclical business line.

Although Porsche was traded on the Frankfurt Stock Exchange (and associated German exchanges), control of the company remained firmly in the hands of the founding families, the Porsche and Piech families. Porsche had two classes of shares, ordinary and preference. The two families held all 8.75 million ordinary shares—the shares which held all voting rights. The second class of share, preference shares, participated only in profits. All 8.

75 million preference shares were publicly traded. Approximately 50% of all preference shares were held by large institutional investors in the United States, Germany, and the United Kingdom; 14% were held by the Porsche and Piech families; and 36% were held by small private investors. As noted by the Chief Financial Officer, Holger Harter, “ As long as the two families hold on to their stock portfolios, there won’t be any external influence on company-related decisions. I have no doubt that the families will hang on to their shares. ” One of the consultants, focused on lean manufacturing techniques and Porsche’s overwhelming levels of subcomponent assemblies and various automotive parts and inventory, was quoted as saying, “ Where is the car factory? This looks like a mover’s warehouse. 1 2 TB0067 Porsche was somewhat infamous for its independent thought and occasional stubbornness when it came to disclosure and compliance with reporting requirements—the prerequisites of being publicly traded. In 2002, the company had chosen not to list on the New York Stock Exchange after the passage of the Sarbanes-Oxley Act. The company pointed to the specific requirement of Sarbanes-Oxley that senior management sign off on the financial results of the company personally as inconsistent with German law (which it largely was) and illogical for management to accept.

Management had also long been critical of the practice of quarterly reporting, and had in fact been removed from the Frankfurt exchange’s stock index in September 2002 because of its refusal to report quarterly financial results (Porsche still reports operating and financial results only semi-annually). Porsche’s management continued to argue that the company believed itself to be quite seasonal in its operations, and did not wish to

report quarterly. It also believed that quarterly reporting only added to short-term investor perspectives, a fire which Porsche felt no need to fuel (see Appendix 4).

Exhibit 1 7, 000 Porsche's Growth in Sales, Income and Margin Operating Margin 28% Millions of euros (€) Sales 6, 000 20. 8% 5, 000 18. 0% 18. 2% 17. 9% 20% 24% 4, 000 13. 6% 3, 000 11. 6% 12. 0% 16% Operating Margin (EBIT / Sales) 12% 2, 000 7. 0% Operating Income (EBIT) 8% 4. 2% 1, 000 2. 0% 0 1996 1997 1998 1999 2000 2001 2002 2003 4% 0% 2004 2005 Note: EBIT = earnings before interest and tax. But, after all was said and done, the company had just reported record profits for the tenth consecutive year (see Exhibit 1).

Returns were so good and had grown so steadily that the company had paid out a special dividend of €14 per share in 2002, in addition to increasing the size of the regular dividend. The company's critics had argued that this was simply another way in which the controlling families drained profits from the company. There was a continuing concern that management came first. In the words of one analyst, "... we think there is the potential risk that management may not rate shareholders' interests very highly. " The motivations of Porsche's leadership team had long been the subject of debate.

The compensation packages of Porsche's senior management team were nearly exclusively focused on current year profitability (83% of executive board compensation was based on performance-related pay), with no management incentives or stock option awards related to the company's share price. Porsche clearly focused on the company's own operational and

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financial results, not the market's valuation—or opinion—of the company. Leadership, however, had clearly built value for all stakeholders in recent years, and had shared many of the fruits of the business, in the form of bonuses, with both management and labor alike. “ We are aware that our lofty ambitions for products, processes, and customer satisfaction can only be achieved with the support of a high-quality and well-motivated team. Here at Porsche, we have such a team—and we believe that they should share in the success of the company by means of special bonus payments. ”

2 Porsche's Growing Portfolio Porsche's product portfolio had undergone significant change as CEO Wiedeking pursued his promise to shareholders that he would grow the firm.

The company had three major vehicle platforms: the premier luxury sports car, the 911; the competitively priced Boxster roadster; and the recently introduced off-road sport utility vehicle, the Cayenne. Porsche had also recently announced that it would be adding a fourth platform, the Panamera, which would be a high-end sedan to compete with Jaguar, Mercedes, and Bentley. The 911 series was still the focal point of the Porsche brand, but many believed that it was growing old and due for replacement. Sales had seemingly peaked in 2001/02, and fallen back more than 15% in 2002/03.

The 911 was a highly developed series with more than 14 current models carrying the 911 tag. The 911 had always enjoyed nearly exclusive ownership of its market segment. Prices continued to be high, and margins some of the very highest in the global auto industry for production models. Although its sales had been historically cyclical, 911 demand was not

priceelastic. The 911 was the only Porsche model which was manufactured and assembled in-house. Boxster. The Boxster roadster had been introduced in 1996 as Porsche's entry into the lower-price end of the sports car market, and had been by all measures a very big success.

The Boxster was also considered an anticyclical move, because the traditional 911 was so high priced that its sales were heavily dependent on the disposable income of buyers in its major markets (Europe, the United States, and the United Kingdom). The Boxster's lower price made it affordable and less sensitive to the business cycle. It did, however, compete in an increasingly competitive market segment. Although the Boxster had competed head-to-head with the BMW Z3 since its introduction in 1996, the introduction of the Z4 in 2003 had drastically cut into Boxster sales. Boxster sales volumes had peaked in 2000/01.

Volume sales in 2003/04 were down to 12, 988, less than half what they had been at peak. Cayenne. The third major platform innovation was Porsche's entry into the sports utility vehicle (SUV) segment, the Cayenne. Clearly at the top end of the market (2002/03 Cayenne sales averaged more than \$70, 000 each), the Cayenne had been a very quick success, especially in the SUVcrazed American market. The Cayenne introduction was considered by many as one of the most successful new product launches in history, and had single-handedly floated Porsche sales numbers in recent years.

The Cayenne's success had been even more dramatic given much pre-launch criticism that the market would not support such a high-priced SUV, particularly one which shared a strong blood-line with the Volkswagen (VW) Touareg. The Porsche Cayenne and VW Touareg had been jointly developed

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by the two companies. The two vehicles shared a common chassis, and in fact were both manufactured at the same factory in Bratislava, Slovakia. To preserve its unique identity, however, Porsche shipped the Cayenne chassis 17 hours by rail to its facility in Leipzig, Germany, where the engine, drive “ Porsche Stays on Course,” Dr.

Wendelin Wiedeking, President and Chief Executive Officer, Porsche Annual Report 2003/04, p. 5. 2 4 TB0067 train, and interior were combined in final assembly. 3 A new six-cylinder version was introduced in 2004 to buoy Cayenne sales after the initial boom of the introduction year, by offering a significantly cheaper model choice. 4 As illustrated by Exhibit 2, Porsche’s platform innovations had successfully grown sales volumes over the past decade. Exhibit 2 Units 0, 000 80, 000 70, 000 60, 000 50, 000 40, 000 30, 000 20, 000 10, 000 0 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 Note: Excludes sales of the discontinued 928 and 944/968 models in 1994-1996. These models totaled 1005 in 1995 and 104 in 1006. 911 sales in 2004 and 2005 include 222 and 660 Carrera GTs, respectively. Porsche’s Expanding Platforms and Growing Sales 911 Boxster Cayenne Panamera. On July 27, 2005, Porsche announced that it would proceed with the development and production of a fourth major model—the Panamera. The name was derived from the legendary Carrera Panamericana long-distance road race held for many years in Mexico.

The Panamera would be a premium class, four-door, four-seat sports coupe, and would compete with the premium sedan models produced by Mercedes Benz and Bentley. Pricing was expected to begin at \$125, 000, rising to \$175, 000. Production was scheduled to begin in 2009 at a scale of 20, 000

units per year. This new model would give Porsche a competitive element in every major premium-product market segment. The Most Profitable Automobile Company in the World Porsche's financial performance and health, by auto manufacturer standards, European or elsewhere, was excellent.

It was clearly the smallest of the major European-based manufacturers with total sales of €6.4 billion in 2004.⁵ This was in comparison to DaimlerChrysler's €142 billion in sales, and Volkswagen's. The engine was, in fact, the only part of the Cayenne which was actually manufactured by Porsche itself. All other components of the vehicle were either outsourced or built in conjunction with other manufacturers.⁴ The six-cylinder engine, however, was actually a Volkswagen engine which had been reconfigured. This had led to significant debate, as Porsche was criticized for degrading the Porsche brand. Comparing Porsche's financial results with other major automakers is problematic. First, Porsche's fiscal year ends July 31. Hence Porsche's financial results for 2004 reported in Exhibit 3 are those for the August 1, 2003, through July 31, 2004, period. Secondly, Porsche announced that beginning with the 2004/05 period, which ended July 31, 2005, it would move to International Financial Reporting Standards (IFRS), rather than the German Commercial Code and special accounting requirements of the German Stock Corporation Law (German Generally Accepted Accounting Principles) which it has followed since it went public in 1984.

These results will not be comparable to previous reporting years, and will require both Porsche and its analysts to reconstruct its financial history following IFRS.³ TB0067⁵ €89 billion. But, as illustrated in Exhibit 3, Porsche

was outstanding by all metrics of profitability and return on invested capital. Porsche's EBITDA, EBIT, and net income margins were the highest among all European automakers in 2004. 6 What also always stood out about Porsche was the average revenue per vehicle. At €83, 671, only DaimlerChrysler was even close. Exhibit 3 European Automaker BMW DaimlerChrysler Fiat Peugeot Porsche Renault Volkswagen

Porsche's Competitive Positioning, 2004 Earnings Measures Sales (millions) € 44, 335 € 142, 059 € 46, 703 € 56, 797 € 6, 359 € 40, 715 € 88, 963 Revenue per vehicle € 39, 622 € 78, 056 € 28, 844 € 19, 354 € 83, 671 € 19, 291 € 18, 369 EBITDA € 5, 780 € 10, 280 € 2, 190 € 4, 502 € 1, 665 € 4, 414 € 7, 140 EBIT € 3, 745 € 4, 612 € 22 € 1, 916 € 1, 141 € 2, 148 € 1, 620 Net Income € 2, 222 € 2, 466 -€ 1, 586 € 1, 357 € 616 € 3, 551 € 677 EBITDA Margin 13. 0% 7. 2% 4. 7% 7. 9% 26. 2% 10. 8% 8. 0% Margin Measures EBIT Net Income Margin Margin 8. 4% 5. 0% 3. 2% 1. 7% 0. 0% -3. 4% 3. 4% 2. 4% 17. 9% 9. 7% 5. 3% 8. 7% 1. % 0. 8% Source: " European Autos," Deutsche Bank, July 20, 2005; " Porsche," Deutsche Bank, September 26, 2005; Thomson Analytics; author estimates. Renault's results included 343 million in extraordinary income in 2004, accounting for net income exceeding EBIT. Porsche's financial results, however, had been the subject of substantial debate in recent years as upwards of 40% of operating earnings were thought to be derived from currency hedging. Porsche's cost-base was purely European euro; it produced in only two countries, Germany and Finland, and both were euro area members.

Porsche believed that the quality of its engineering and manufacturing were at the core of its brand, and it was not willing to move production beyond

Europe (BMW, Mercedes, and VW had all been manufacturing in both the United States and Mexico for years). Porsche's sales by currency in 2004 were roughly 45% European euro, 40% U. S. dollar, 10% British pound sterling, and 5% other (primarily the Japanese yen and Swiss franc). Porsche's leadership had undertaken a very aggressive currency hedging strategy beginning in 2001 when the euro was at a record low against the U. S. dollar. In the following years, these financial hedges (currency derivatives) proved extremely profitable. For example, nearly 43% of operating earnings in 2003 were thought to have been derived from hedging activities. Although profitable, many analysts argued the company was increasingly an investment banking firm rather than an automaker, and was heavily exposed to the unpredictable fluctuations between the world's two most powerful currencies, the dollar and the euro. Exhibit 4 European Automaker BMW DaimlerChrysler Fiat Peugeot Porsche Renault Volkswagen

Return on Invested Capital (ROIC) for European Automakers, 2004 Operating Margin Sales (millions) € 44, 335 € 142, 059 € 46, 703 € 56, 797 € 6, 359 € 40, 715 € 88, 963 EBIT € 3, 745 € 4, 612 € 22 € 1, 916 € 1, 141 € 2, 148 € 1, 620 Taxes € 1, 332 € 1, 177 -€ 29 € 676 € 470 € 634 € 383 EBIT After-tax € 2, 413 € 3, 435 € 51 € 1, 240 € 671 € 1, 514 € 1, 237 Interest Bearing debt € 1, 555 € 9, 455 € 24, 813 € 6, 445 € 2, 105 € 7, 220 € 14, 971 Invested Capital Stockholders' equity € 17, 517 € 33, 541 € 5, 946 € 13, 356 € 2, 323 € 16, 444 € 23, 957 Invested Capital € 19, 072 € 42, 996 € 30, 759 € 19, 801 € 4, 428 € 23, 664 € 38, 928 Capital Turnover 2. 2 3. 30 1. 52 2. 87 1. 44 1. 72 2. 29 ROIC 12. 65% 7. 99% 0. 17% 6. 26% 15. 15% 6. 40% 3. 18%

Source: " European Autos," Deutsche Bank, July 20, 2005; " Porsche,"

Deutsche Bank, September 26, 2005; Thomson Analytics; author estimates. Invested Capital = total stockholders' equity + gross interest-bearing debt. Capital turnover = sales/invested capital. ROIC (return on invested capital) = EBIT - taxes/invested capital. ROIC. It was Porsche's return on invested capital (ROIC), however, which had been truly exceptional over time.

The company's ROIC in 2004—following Deutsche Bank's analysis presented in Exhibit 4—was 15.15%. This was clearly superior to all other European automakers; BMW's ROIC was second highest at 12.65%. Other major European automakers struggled to reach 6% to 7%. EBITDA (earnings before interest, taxes, depreciation, and amortization) is frequently used as the income measure of pure business profitability. EBIT (earnings before interest and taxes) is similar but is reduced by depreciation and amortization charges associated with capital asset and goodwill write-offs. 6 6 TB0067

This ROIC reflected Porsche's two-pronged financial strategy: 1) superior margins on the narrow but selective product portfolio; and 2) leveraging the capital and capabilities of manufacturing partners in the development and production of two of its three products. The company had successfully exploited the two primary drivers of the ROIC formula: ROIC = EBIT after-tax / Sales x Sales / Invested Capital. The first component, operating profits (EBIT, earnings before interest and taxes) after-tax as a percent of sales—operating margin—was exceptional at Porsche due to the premium value pricing derived from its global brand of quality and excellence.

This allowed Porsche to charge premium prices and achieve some of the largest of margins in the auto industry. As illustrated in Exhibit 4, Porsche's operating profits after-tax of €671 million produced an operating margin

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after-tax of 10.55% (€671 divided by €6,359 in sales), the highest in the industry in 2004. The second component of ROIC, the capital turnover ratio (sales divided by invested capital)—velocity—reflected Porsche's manufacturing and assembly strategy.

By leveraging the Valmet and VW partnerships in the design, production, and assembly of both the Boxster (with Valmet of Finland) and the Cayenne (with Volkswagen of Germany), Porsche had achieved capital turnover ratios which dwarfed those achieved by any other European automaker. Porsche's capital turnover ratio had surpassed all other European automakers consistently over the past decade. As illustrated by Exhibit 5, Porsche's growing margins and relatively high velocity had sustained a very impressive ROIC for many years. In recent years, however, invested capital had risen faster than sales.

But Porsche was not adding fixed assets to its invested capital basis, but cash. The rising cash balances were the result of retained profits (undistributed to shareholders) and new debt issuances (raising more than 600 million in 2004 alone). As a result, fiscal 2003/04 had proven to be one of Porsche's poorest years in ROIC.

Exhibit 5 2.5 Porsche's Velocity, Margin, and ROIC

Year	Operating Margin	Velocity	ROIC
1996	6.4%	1.97	12.5%
1997	6.0%	1.99	11.7%
1998	6.4%	1.81	11.6%
1999	8.0%	1.91	15.3%
2000	0.91	1.19	10.5%
2001	0.84	1.21	9.9%
2002	6.0%	1.21	7.3%
2003	3.8%	1.21	4.6%
2004	2.0%	1.21	2.4%
2005	3.7%	1.21	4.5%

Operating margin = (EBIT - Taxes) / Sales. Invested capital = cash + net working capital + net fixed assets. Porsche's minimal levels of invested

capital resulted from some rather unique characteristics. Invested capital is defined a number of ways, but Vesi used her employer's standardized definition of cash plus net working capital plus net fixed assets. As illustrated in Exhibit 6, Porsche's invested capital base TB0067 7 had been growing rapidly in recent years, but not because of additional fixed asset investments. Porsche's invested capital was growing primarily because of its accumulation of cash. 8 Vesi was concerned that using this measure of "invested capital" led to a distorted view of the company's actual performance. Porsche's minimal fixed-asset capital base resulted from the explicit strategy of the company as executed over the past decade.

The development and manufacturing and assembly of the Cayenne was a clear example:

- Porsche had spent only \$420 million in the development of the Cayenne. Auto analysts estimated that any other major automaker would have spent between \$1.2 and \$1.8 billion.
- Porsche had effectively avoided these costs and investments by co-producing the Cayenne with Volkswagen. The Cayenne shared some 65% of its parts and modules with the VW Touareg, with only 13% of the Cayenne's actual wholesale value being derived from parts developed and manufactured by Porsche itself. The production agreement between Porsche and VW made VW responsible for all costs associated with quality problems arising at VW's manufacturing facilities. Porsche paid VW a unit price for each Cayenne body produced in VW's assembly facility in Bratislava, Slovakia. Porsche had successfully off-loaded both cost and risk.

Exhibit 6 Asset Structure Cash Net working capital Net fixed assets Invested capital Liability Structure Short-term debt Long-term debt Total debt Equity Invested capital Porsche's Managerial Balance

Sheet (millions of euros) 996 € 227 38 487 € 753 1997 € 281 116 578 € 975
 1998 € 466 132 590 € 1, 188 1999 € 730 225 649 € 1, 604 2000 € 823 258
 755 € 1, 835 2001 € 1, 121 369 960 € 2, 449 2002 € 1, 683 (355) 2, 746 € 4,
 073 2003 € 1, 766 (382) 3, 215 € 4, 599 2004 € 2, 791 403 3, 797 € 6, 992
 2005 € 4, 325 (131) 3, 641 € 7, 834 €8 19 € 27 726 € 753 €7 124 € 131 844
 € 975 € 10 114 € 124 1, 064 € 1, 188 € 52 107 € 159 1, 445 € 1, 604 € 20 82
 € 102 1, 733 € 1, 835 € 158 (49) € 108 2, 341 € 2, 449 € 137 850 € 987 3,
 086 € 4, 073 € 70 859 € 929 3, 670 € 4, 599 € 649 1, 641 € 2, 290 4, 702 €
 6, 992 € 1, 107 2, 026 € 3, 133 4, 701 € 7, 834

Net working capital = accounts receivable, inventories, and prepaid expenses, less accounts payable and accrued expenses. This assumes 'provisions for risk and charges' as equity. Porsche Changes Tack The summer and fall of 2005 saw a series of surprising moves by Porsche. First, Porsche announced that the €1 billion investment to design and manufacture the new Panamera would be largely funded by the company itself. Although the introduction of the Panamera had been anticipated for quite some time, the market was surprised that Porsche intended to design and build the car—and its manufacturing facility—nearly totally in-house.

The new sports coupe was to be produced in Leipzig, Germany, at the existing Porsche facility, although a substantial expansion of the plant would be required. As opposed to the previous new product introductions, the Boxster and the Cayenne, there would be no major production partner involved. Porsche CEO Wendelin Wiedeking specifically noted this in his press release: “ There are no plans for a joint venture with another car maker. But to ensure the profitability of this new model series, we will

cooperate more closely than so far with selected system suppliers. 9 The German share of the value of the Panamera would be roughly 70%. Like the 911, Boxster, and Cayenne, the Panamera would bear the Made in Germany stamp. This methodology defines invested capital by assets, the left-hand side of the managerial balance sheet. Alternative definitions of invested capital focus on the right-hand side of the balance sheet; for example, as stockholder equity plus interest-bearing debt. Either version can also be netted for cash holdings under different methods. 8 Porsche's cash and marketable securities grew from €2. billion in 2004 to over €4. 3 billion at the end of 2005 (July 31, 2005). Credit Suisse First Boston had in fact noted on September 21, 2005, just days before the VW announcement, that, " In our view, the only disappointment is that management indicated that the company would not look into returning cash to shareholders in the next 18 months. " 9 " Go Ahead for Porsche's Fourth Model Series," Porsche Press Release, July 27, 2005. 7 8 TB0067 The second surprise occurred on September 25, 2005, with the announcement to invest €3 billion in VW.

Porsche AG, Stuttgart, seeks to acquire a share of approximately 20 percent in the stock capital of Volkswagen AG, Wolfsburg, entitled to vote. Porsche is taking this decision because Volkswagen is now not only an important development partner for Porsche, but also a significant supplier of approximately 30 percent of Porsche's sales volume. In the words of Porsche's President and CEO: " Making this investment, we seek to secure our business relations with Volkswagen and make a significant contribution to our own future plans on a lasting, long-term basis. Porsche is in a position to financethe acquisition of the planned share in Volkswagen through its own,

existing liquidity. After careful examination of this business case, Porsche is confident that the investment will prove profitable for both parties. ... The planned acquisition is to ensure that... there will not be a hostile takeover of Volkswagen by investors not committed to Volkswagen's long-term interests. In the words of Porsche's President and CEO: " Our planned investment is the strategic answer to this risk.

We wish in this way to ensure the independence of the Volkswagen Group in our own interest. This ' German solution' we are seeking is an essential prerequisite for stable development of the Volkswagen Group and, accordingly, for continuing our cooperation in the interest of both Companies. " " Acquisition of Stock to Secure Porsche's Business," Porsche AG (press release), September 25, 2005. Porsche would spend approximately €3 billion to take a 20% ownership position in VW. This would make Porsche VW's single largest investor, slightly larger than the government of Lower Saxony. 0 It clearly eliminated any possible hostile acquisitions which may have been on the horizon (DaimlerChrysler was rumored to have been interested in raiding VW.) The announcement was met by near-universal opposition The family linkages between the two companies were well known. Ferdinand K. Piech, one of the most prominent members of the Piech family which, along with the Porsche family, controlled Porsche, was the former CEO (he retired in 2002) and still Chairman of Volkswagen. He was the grandson of Ferdinand Porsche, the founder of Porsche.

Accusations of conflict of interest were immediate, as were calls for his resignation, and the denial of Porsche's request for a seat on VW's board. Although VW officially welcomed the investment by Porsche, Christian Wulff,

VW's board member representing the state of Lower Saxony where VW was headquartered, publicly opposed the investment by Porsche. In the eyes of many, the move by Porsche was a return to German corporate cronyism. For years, " Deutschland AG" was emblematic of the cosy network of cross-shareholdings and shared non-executive directorships that insulated Germany from international capitalism.

Wendelin Wiedeking, Porsche's chief executive, himself invoked the national angle, saying this: " German solution was essential to secure VW, Europe's largest carmaker, against a possible hostile takeover by short-term investors. " " Shield for Corporate Germany or a Family Affair? VW and Porsche Close Ranks," Financial Times, Tuesday, September 27, 2005, p. 17. Germany, although long known for complex networks of cross-shareholdings, had effectively unwound most of these in the 1990s.

The German government had successfully accelerated the unwinding by making most cross-shareholding liquidations tax-free in recent years, and both the financial and nonfinancial sectors had sold literally billions of euros in shares. This move by Porsche and VW was seen as more of a personal issue—Ferdinand Piech—rather than a national issue of German alliances. Many Porsche investors had agreed, arguing that if they had wanted to invest in VW, they would have done it themselves. The resulting ownership structure of Volkswagen in October 2005 was: 18. 3% Porsche; 18. 2% State of Lower Saxony; 13. 0% Volkswagen; 8. 58% Brandes Investment Partners; 3. 5% Capital Group; and 38. 19% widely distributed. Porsche still possessed the option to purchase another 3. 4%. 10 TB0067 9 There were also potential strategic conflicts between the two companies. Volkswagen's premium

segment company, Audi, was a distinct competitor to Porsche, particularly in light of the new Panamera project. VW itself had fallen on bad times (see Exhibit 3), and many VW watchers believed that the company needed activist shareholders.

VW and its Audi unit were both suffering from high wage costs in German factories, and VW had been seeking wage concessions from many of its unions to regain competitiveness and profitability. Porsche had a reputation of being soft on German unions, and with the growing presence of both Porsche and Ferdinand Piech, critics feared VW would back away from its wage-reduction push. Porsche was not expected to be as cost-conscious or to push VW to make drastic strategic changes.

Instead, Porsche was expected to push VW to underwrite a number of the new models and platforms Porsche was in the process of introducing. There were, in fact, lingering allegations that a number of VW's new product introductions had been delayed by the Cayenne's production in 2003 and 2004. Shareholders in Porsche—the nonfamily-member shareholders—were both surprised and confused by this dramatic turn of events. Although the arguments for solidifying and securing the Porsche/ VW partnership were rational, the cost was not.

At €3 billion, this was seemingly an enormous investment in a nonperforming asset. Analysts concluded that the potential returns to shareholders, even in the form of a special dividend, were now postponed indefinitely; shareholders would not “see the money” for years to come. The move was also seen by some as an acknowledgment by Porsche that it could no longer expand into new product categories without significantly larger capital and

technical resources. Automotive electrical systems, for example, were increasingly complex and beyond capabilities possessed in-house by Porsche.

The interest in VW, Europe's second largest automaker to DaimlerChrysler, would surely provide the company with access to key resources. But why weren't these resources accessible through partnerships and alliances, without the acquisition of one-fifth ownership in Europe's largest moneyloser? The announcement of Porsche's intention to take a 20% equity interest in Volkswagen in September 2005 was greeted with outright opposition on the part of many shareholders in both Volkswagen and Porsche. Major investment banks like Deutsche Bank immediately downgraded Porsche from a buy to a sell, arguing that the returns on the massive investment, one €3 billion, would likely never accrue to shareholders. 11 Although Porsche and VW were currently co-producing the Porsche Cayenne and Volkswagen Touareg, this ownership interest would take the two companies far down a path of cooperation way beyond the manufacture of a sport utility vehicle. Although Porsche had explained its investment decision to be one which would assure the stability of its future cooperation with VW, many critics saw it as a choice of preserving the stakes of the Porsche and Piech families at the expense of nonfamily shareholders.

The question remained as to whether this was indeed a good or bad investment by Porsche, and good or bad for whom? Vesi wondered if her position on Porsche might have to, in the end, distinguish between the company's ability to generate results for stockholders versus its willingness to do so. Why should a small and highly profitable maker of sports cars

suddenly hitch its fortunes to a lumbering and struggling mass-producer? That was the question that some alarmed shareholders asked this week when Porsche, the world's most profitable carmaker, announced plans to buy 20% stake in Volkswagen (VW), Europe's biggest carmaker.

To some critics of the deal, Porsche's move looked like a return to cosy, German corporatism at its worst. Since January 2002, when a change in the law encouraged German companies to sell their cross-shareholdings in each other, free of capital gains tax, new foreign shareholders have often shaken up fossilised German management. A deal with friendly compatriots from Porsche might rescue VW from this distasteful fate, particularly since foreign hedge funds and corporate raiders have been rumored to be circling VW. “

Business: Keeping It in the Family,” The Economist, October 1, 2005. 1 “

Porsche: We may never see the cash; downgrade to sell,” Deutsche Bank,

September 26, 2005. TB0067 10 Appendix 1 (Millions of euros) Sales Cost of

goods sold Gross profits Porsche's Statement of Income, 1996-2005 (period

ending July 31) 1996 € 1, 438 1, 177 € 261 243 15 64 € 97 6. 8% 68 € 29 2.

0% 3 € 26 1 0 € 25 1. 7% ----1997 € 2, 093 1, 648 € 446 339 21 67 € 195 9.

3% 108 € 87 4. 2% 7 € 81 9 1 € 70 3. 4% 45. 6% 40. 0% 1998 € 2, 519 1,

853 € 667 439 17 88 € 334 13. 2% 157 € 176 7. 0% 13 € 164 22 € 142 5. 6%

20. 4% 12. 4% 1999 € 3, 161 2, 154 € 1, 007 571 29 84 € 550 17. % 184 €

366 11. 6% 12 € 354 164 € 191 6. 0% 25. 5% 16. 3% 2000 € 3, 648 2, 527 €

1, 121 625 26 114 € 636 17. 4% 197 € 439 12. 0% 12 € 427 220 € 207 5. 7%

15. 4% 17. 3% 2001 € 4, 441 3, 062 € 1, 380 793 61 87 € 735 16. 5% 133 €

602 13. 6% 14 € 588 318 € 270 6. 1% 21. 8% 21. 2% 2002 € 4, 857 2, 981 €

1, 877 914 79 110 € 1, 152 23. 7% 279 € 873 18. 0% 48 € 825 363 (0) € 462

9. 5% 9. 4% -2. 6% 2003 € 5, 582 3, 250 € 2, 332 1, 187 116 147 € 1, 409
 25. 2% 392 € 1, 017 18. 2% 88 € 928 363 0 € 565 10. 1% 14. 9% 9. 0% 2004
 € 6, 359 3, 787 € 2, 572 1, 254 99 248 € 1, 665 26. % 525 € 1, 141 17. 9%
 58 € 1, 082 470 (4) € 616 9. 7% 13. 9% 16. 5% 2005 € 6, 574 3, 501 € 3, 073
 1, 539 172 169 € 1, 875 28. 5% 510 € 1, 365 20. 8% 127 € 1, 238 459 (4) €
 783 11. 9% 3. 4% -7. 6% Selling, general & admin expenses Non-operating
 income Other income/expense, net EBITDA EBITDA/sales Depreciation &
 amortization Earnings before interest and tax EBIT/sales Interest expense on
 debt Earnings before taxes (EBT) Income taxes Minority interest Net income
 available to common Net income/sales (ROS) Sales growth Earnings growth

Source: Thomson Analytics, June 2006, and author calculations. Appendix 2
 (Millions of euros) Assets Cash ; amp; equivalents Receivables, net
 Inventories Prepaid expenses Total current assets Porsche's Balance Sheet,
 1996-2005 (period ending July 31) 1996 1997 1998 1999 2000 2001 2002
 2003 2004 2005 € 227 91 199 23 € 540 €0 60 € 1, 324 917 € 407 21 € 1,
 027 € 281 170 297 47 € 795 € 12 5 € 1, 536 994 € 541 20 € 1, 374 € 466
 196 328 37 € 1, 027 € 10 5 € 1, 623 1, 062 € 561 14 € 1, 617 730 202 357
 42 € 1, 332 € 30 9 € 1, 683 1, 183 € 501 110 € 1, 981 € 823 321 396 45 € 1,
 585 € 177 14 € 1, 797 1, 310 € 487 76 € 2, 340 € 1, 121 439 468 29 € 2, 056
 € 253 38 € 1, 960 1, 399 € 561 108 € 3, 016 € 1, 683 638 487 50 € 2, 858 €
 539 39 € 3, 607 1, 652 € 1, 955 214 € 5, 604 € 1, 766 823 539 42 € 3, 170 €
 552 42 € 4, 122 1, 847 € 2, 276 346 € 6, 385 € 2, 791 939 726 23 € 4, 479 €
 733 21 € 4, 724 2, 116 € 2, 607 436 € 8, 276 € 4, 325 971 572 17 € 5, 885 €
 1, 211 27 € 4, 486 2, 378 € 2, 108 295 € 9, 525

Long term receivables Investments in unconsol subsidiaries Property, plant ;
 amp; equipment, gross Accumulated depreciation Property, plant ; amp;
 equipment, net Other assets Total Assets Liabilities Accounts payable ST
 debt ; amp; current portion due LT debt Income taxes payable Other current
 liabilities Current liabilities, total Long term debt Provision for risks ; amp;
 charges Deferred taxes Other liabilities Total liabilities Shareholders' Equity
 Non-equity reserves & minority interest Common Equity Shareholders'
 equity, total Total liabilities ; amp; shareholders' equity Common shares
 outstanding (millions) 117 8 3 156 € 283 € 17 481 1 1 € 782 € 148 7 10 241
 € 406 € 116 541 4 4 € 1, 071 € 159 10 8 262 € 439 € 114 648 n/a 0 € 1, 202
 € 193 52 10 174 € 429 € 102 856 n/a 5 € 1, 392 € 240 20 17 248 € 525 €
 102 951 (22) 2 € 1, 558 € 236 158 28 303 € 725 €0 1, 312 (52) 2 € 1, 987 €
 305 137 200 1, 027 € 1, 668 € 317 1, 619 97 437 € 4, 138 € 337 70 71 1,
 378 € 1, 856 € 337 1, 916 173 350 € 4, 631 € 368 649 61 855 € 1, 933 € 1,
 457 2, 378 182 2 € 5, 953 € 440 1, 107 187 1, 064 € 2, 798 € 1, 985 1, 281
 36 5 € 6, 105 € 10 235 € 245 € 1, 027 17. €5 298 € 303 € 1, 374 17. 5 €0
 416 € 416 € 1, 617 17. 5 €2 587 € 589 € 1, 981 17. 5 €0 782 € 782 € 2, 340
 17. 5 €0 1, 028 € 1, 028 € 3, 016 17. 5 €1 1, 466 € 1, 467 € 5, 604 17. 5 (€ 0)
 1, 755 € 1, 755 € 6, 385 17. 5 €6 2, 317 € 2, 323 € 8, 276 17. 5 €8 3, 412 €
 3, 420 € 9, 525 17. 5 Source: Thomson Analytics, June 2006, and author
 calculations. TB0067 11 Appendix 3 (Millions of euros) Porsche's Statement
 of Cash Flow, 1996-2005 (period ending July 31) 1996 1997 1998 1999 2000
 2001 2002 2003 2004 2005

Operating Activities Income before extraordinary items Depreciation &
 amortization Other Cash Flow Funds From/For Other Operating Activities Net

Cash Flow From Operating Activities Investing Activities Capital Expenditures
 Additions To Other Assets Increase In Investments Disposal of Fixed Assets
 Net Cash Flow From Investing Activities Financing Activities Net Proceeds
 From Sales/Issue of Com/Prf Stock Com/Prf Purchased, Retired, Converted,
 Redeemed Long Term Borrowings Inc(Dec) In ST Borrowings Reduction In
 Long Term Debt Cash Dividends Paid - Total Net Cash Flow From Financing
 Activities Exchange Rate Effect Cash & Cash Equivalent - Inc(Dec) € 25 74
 47 26 € 171 € 71 127 (0) 22 € 220 € 142 157 (7) 72 € 363 € 191 184 23 (5) €
 392 € 210 197 11 (22) € 396 € 270 133 16 151 € 570 € 462 279 26 611 € 1,
 377 € 565 392 423 77 € 1, 456 € 612 525 515 (349) € 1, 303 € 779 510 42
 (157) € 1, 175 (€ 184) (15) (14) (€ 214) (€ 230) n/a n/a (€ 230) (€ 174) (2) (0)
 10 (€ 166) (€ 145) (12) (7) 27 (€ 136) (€ 257) n/a n/a 8 (€ 249) (€ 306) n/a
 (1) 23 (€ 285) (€ 1, 833) 831 (€ 1, 002) (€ 1, 338) n/a 309 (€ 1, 028) (€ 1,
 265) n/a 478 (€ 787) (€ 851) (63) (243) 226 (€ 932) €0 6 1 €8 (30) €0 102
 (33) (5) € 64 54 €0 (13) (€ 13) 185 €0 49 (21) (22) €6 1 263 €0 (36) (22) (€
 58) 4 93 €0 37 (26) € 11 2 298 0 339 (102) (45) € 192 (5) 562 €0 (39) (297)
 (€ 336) (8) 84 €0 639 n/a (0) (59) € 580 5 1, 025 €6 147 (69) € 84 (32) 296

Source: Thomson Analytics, November 2005, and author calculations.

Appendix 4 Porsche Dispenses with Listing in New York Stuttgart. The preferred stock of Dr. Ing. h. c. F. Porsche AG, Stuttgart, will continue to be listed exclusively on German stock exchanges. All considerations about gaining an additional listing in the U. S. A. have been laid aside by the Porsche Board of Management. The sports car manufacturer had been invited to join the New York Stock Exchange at the beginning of the year. The Chairman of the Board of Management at Porsche, Dr.

Wendelin Wiedeking explained the decision: “ The idea was certainly attractive for us. But we came to the conclusion that a listing in New York would hardly have brought any benefits for us and our shareholders and, on the other hand, would have led to considerable extra costs for the company. ” The crucial factor in Porsche’s decision was ultimately the law passed by the U. S. government this summer (the “ Sarbanes-Oxley Act”), whereby the CEO and the Director of Finance of a public limited company listed on a stock exchange in the U. S. A. have to swear that every balance sheet is correct and, in the case of incorrect specifications, are personally liable for high financial penalties and even up to 20 years in prison.

In Porsche’s view, this new American ruling does not match the legal position in Germany. In Germany, the annual financial statement is passed by the entire Board of Management and is then presented to the Supervisory Board, after being audited and certified by chartered accountants. The chartered accountants are commissioned by the general meeting of shareholders and they are obliged both to report and to submit the annual financial statement to the Supervisory Board. The annual financial statement is only passed after it is approved by the Supervisory Board. Therefore there is an overall responsibility covering several different committees and, as a rule, involving over 20 persons, including the chartered accountants.

The Porsche Director of Finance, Holger P. Harter, made the following comments: “ Nowadays in Germany, the deliberate falsification of balance sheets is already punished according to the relevant regulations in the Commercial Code (HGB) and the Company Act (Aktiengesetz). Any special treatment of the Chairman of the Board of Management or the Director of

Finance would be illogical because of the intricate network within the decision-making process; it would also be irreconcilable with current German law. " Source: Porsche, News Release of October 16, 2002. 12 TB0067
Appendix 5 Porsche's Share Price, 2004-2006 Source: www. porsche. com.
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