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How Dr. Z Plans to Fix Mercedes

With the disastrous marriage to Chrysler behind him, Daimler CEO Dieter Zetsche wants to breathe new life into the German luxury-car maker by reshaping the entire company. Think hip and electric.

BY PETER GUMBEL

No. 23

HOW EASY SHOULD IT BE to climb into the back of a Mercedes-Benz wearing ski boots? And how important is it for the quality image of the brand that you can trample with those boots on the car's door frame without the risk of denting it?

At the Stuttgart headquarters of Daimler AG, the "ski-boot test" is one of dozens of fundamental questions that engineers, designers, and product and procurement managers are poring over in weekly meetings in a third-floor conference room near the Untertürkheim engine plant. It's all part of CEO Dieter Zetsche's (pronounced TSET-sheh, and you may remember him as "Dr. Z") plan to revamp the carmaker, an overhaul he hopes will have a profound influence on the future of the company—and especially on its beleaguered finances and flagging competitiveness.

Daimler—which with 2008 sales of $140 billion dropped to No. 23 on *Fortune's* Global 500 list from the

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11th slot—is in a tough spot. As sales of premium autos have slumped, the automaker has slowed production and sent thousands of its workers home on paid leave. In the last quarter of 2008 and the first three months of this year, the company sold 25% fewer autos and lost $4.8 billion before interest and taxes. At the truck division, which accounts for one-quarter of its revenue, unit sales are down by 40%. The economic downturn is only partly to blame. Daimler's preeminence in the luxury-auto segment is being eaten away by German rivals BMW and Audi (amazingly, Audi has stayed profitable during the crisis).

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The man tasked with rebuilding Daimler is a familiar figure to many Americans. Earlier in the decade Dr. Z, who has a Ph.D. in engineering, appeared in TV ads exhorting consumers to buy Chrysler cars. Chrysler was Daimler's problem acquisition back then, and Zetsche was the top manager dispatched to Auburn Hills, Mich., to sort out its troubled operations. He returned to Germany and took over as Daimler CEO in 2006.

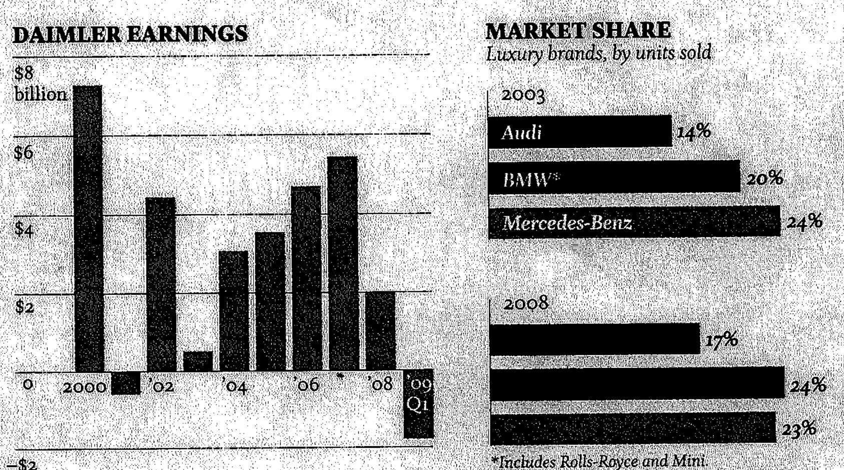
In late April, Zetsche unloaded Daimler's remaining 19.9% Chrysler stake, ending a decade-long nightmare for the German company that has cost its shareholders tens of billions of dollars in lost value. These days Zetsche is wary of the spotlight, but behind the scenes he and his team are moving as fast as they can to deal with two existential questions: how to weather the brutal downturn, and how to come roaring out of it with renewed competitive vigor. "In a time of enormous change," he tells *Fortune*, "we're doing everything to push the pace of progress faster than the competition."

It won't be easy. During an interview the CEO looks weary after a grueling six months of crisis management, with little of the sprightliness that was the hallmark of the old Dr. Z. He's no longer boasting about corporate prowess either, but talks soberly about how the market downturn is taking place amid a host of scientific and environmental challenges to the industry, as consumers and regulators demand greater fuel efficiency and lower emissions. "Our industry hasn't been through such a phase of fundamental technological change for a very, very long time," he says. But make no mistake: Even in his new incarnation, the doctor is hard at work.

ZETSCHE IS WAGING THE BATTLE on several fronts. The ski-boot test is part of a huge top-to-bottom production rethink that focuses on finding economies of scale; Zetsche describes it as a "very fundamental change to our business model." The repercussions aren't limited just to Daimler. *Fortune* has learned that its talks with rival BMW about a possible joint procurement agreement to save costs on parts have gone far beyond the theoretical stage. The discussions are now taking place on a regular and detailed basis—with antitrust lawyers in the room. At the same time Zetsche is redefining the very essence of the heralded Mercedes brand. The carmaker is putting the finishing touches on a new range of its lowest-priced Mercedes, set to be launched in the next two to three years. They are aimed squarely at younger, fashion-conscious buyers whom Zetsche hopes will replace the aging baby boomers who have been Mercedes' core consumers. The CEO is also making a huge bet on the future: He and his R&D team are trying to turn Daimler into a leading player in the still unproven world of lithium-ion battery technology to power hybrid and electric cars. The company has enlisted a series of partners in Germany and the U.S., including the electric-roadster maker Tesla Motors; in May, Daimler paid $50 million for a 10% stake in the San Carlos, Calif., firm. A month later Tesla announced it would receive $465 million in loans from the U.S. Department of Energy to finance production of an electric family sedan. While bud-

MERCEDES GOES INTO A SKID

The German automaker is losing money as well as ground to rivals Audi and BMW.



SOURCES: BLOOMBERG; IHS GLOBAL INSIGHT

UNDER THE HOOD *Daimler is now designing its models, including this new E-Class, to share more parts with one another. It is also working with BMW to reduce supplier costs.*

gets for virtually everything else at Daimler have been cut in these lean times, spending on R&D has barely been touched.

Zetsche's quest has already won over some on Wall Street. Goldman Sachs's auto analysts reckon that Daimler "could morph into the best restructuring story in the sector." But skeptics abound. Morgan Stanley estimates that Daimler stock, which has risen 50% to a recent price of $34 from its low of $22 in March, is about double what it should be, and it recommends that investors "stop for a breath." Peter Schmidt, who runs the British consultancy Automotive Industry Data, is another doubter. He calls Zetsche "a brilliant PR guy" but says that Daimler "is handicapped right, left, and center" by a legacy of poor management and uneconomic practices. The upshot, says Schmidt: "Audi has outmaneuvered Zetsche and his team with humiliating ease."

Zetsche, of course, disagrees and points to his track record of delivering results at Daimler. An aggressive cost-cutting and quality-improvement program he put in place when he took over as CEO (at a time when Mercedes autos were hurt by uncharacteristic quality problems) brought quick savings and helped restore the brand's dented image. Reacting to the current crisis, Zetsche in April announced a plan that cuts $5.5 billion, thanks largely to a landmark deal with labor representatives that postponed an already agreed-on pay increase and reduced the pay and hours of those still working in exchange for job guarantees. To make the deal more palatable to the firm's strong unions, Zetsche agreed to slash his own salary and that of his management team for this year. With the company burning through cash, he recently replenished its coffers by selling a 9.1% stake to Abu Dhabi's Aabar Investments for $2.7 billion. Now that he's stanched the bleeding, the good doctor is gearing up for some delicate surgery to cut costs even further while revitalizing the Mercedes product pipeline.

While budgets for virtually everything else at Daimler have been cut in these lean times, R&D spending has barely been touched.

WEDNESDAY TECHNICAL MEETINGS are presided over by chief operating officer Rainer Schmückle, who can often be seen walking around with a sheaf of printed spreadsheets. Over the past three years he and his team have broken down Mercedes cars into 90 separate modules, or clusters of components, and have been figuring out how to install them in as many models as possible. The first fruit of those meetings is now hitting showrooms: the new Mercedes E-Class sedan, which was launched in Europe earlier this year and will be sold in the U.S. starting this month (retail price: $49,000 and up). It is the first model to use "significant" amounts of parts already found in other Mercedes cars, Schmückle says. It's just a start. Only when the next-generation C-Class goes into production in four years' time will this module strategy be 100% implemented. But the potential savings are big. Schmückle won't give precise figures but says cost reductions will be in the hundreds of millions of dollars.

Across town in the welding shop at the Sindelfingen plant, you can see the program in action for the new E-Class. Trays with an array of parts are pushed up against the line for robots to grab and fix in place. Look more carefully at the coded identification numbers, and you'll see that some of the parts, such as metal brackets for the engine compartment, are identical to ones already used in C-Class models.

Industry specialists say it's about time Mercedes got serious about economies of scale. Audi and sister company VW were much quicker to spot the potential for cost savings and other efficiencies from sharing the same platforms. Audi's A3, for example, is essentially a rebadged VW Golf. The guts of BMW's 7 Series and 5 Series models also are broadly similar. Its compact 1 Series, meanwhile, is a 3 Series with the back lopped off. "Zetsche is last," says consultant Schmidt. "Mercedes is going for a commonality that you've had for donkey's years elsewhere."

Going forward, a lot of parts will have specifications identical not just to other Mercedes models' but also to BMWs'. The company is cautious about disclosing much about its joint procurement talks with BMW. Schmückle says he sits down with Herbert Diess, his counterpart at BMW, every couple of weeks to discuss what the two firms might be able to do together in the area of purchasing. As a precaution the talks have been reported to the German

Video *Fortune* senior editor Alex Taylor looks at Daimler's future prospects at **fortune.com/global500**

antitrust authorities. "The rules are laid down," Schmückle says. The logic is clear: Both companies produce about 1 million cars apiece, making them relative minnows in the auto industry. Both already use many of the same suppliers. And both try to push the envelope with their technology.

Word of these discussions has caused a buzz of excitement in the German media—and rumors that the link-up may ultimately involve more than just joint purchasing. BMW's CEO Norbert Reithofer quashed some of the wilder talk in a recent interview with the German newspaper *Frankfurter Allgemeine Zeitung*. He confirmed that the two companies are cooperating on purchases of elements such as gearboxes, but also made clear that he wouldn't agree to anything that might "water down" the BMW brand. Daimler, too, has no interest in producing anything that could be mistaken for a BMW.

OPERATIONS PEOPLE aren't the only ones fussing about what makes a Mercedes a Mercedes. The marketing division is busily at work on a new brand strategy. Over the next three years Mercedes will release new versions of its two smallest cars, the A- and B-Class models, and Klaus Maier, executive vice president of sales and marketing for Mercedes cars, says they will be "younger, fresher, and more stylish," marking a significant break with the way consumers view Mercedes. They are part of a push by the company to attract a younger generation of first-time Mercedes buyers in a way that the smaller models, until now, have largely failed to do. Smart, the runaround urban car that Daimler has spent years trying to make profitable, also takes aim at younger consumers, although Smarts are deliberately not branded as Mercedes. Exactly what "younger, fresher, and more stylish" actually means in practice is a closely guarded secret, but there's more than a sporting chance that it will also mean green. To be more precise: electric.

As for that lithium-ion battery technology, the game plan is for Daimler to quickly become an industry leader. In December, Daimler signed a deal with Germany's Evonik Industries to create a battery joint venture. And one of the purposes of the Tesla deal is to accelerate the rollout of a range of electric cars. Later this year 1,000 Smart cars equipped with Tesla power packs will be let loose on the streets of London in a market test. Tesla's chairman, Elon Musk, says the two companies have worked on the Smart project for more than 18 months and hope it will turn into a large fleet. It is, however, hard to fathom the economics of putting advanced batteries, which now can cost $15,000 each, into a $12,000 car. Musk also hints that Daimler will announce another battery-powered-vehicle program, although he won't give details. "If I were Daimler, I'd have multiple irons in the fire," he says.

Daimler has experimented with batteries for years, but the heavy emphasis is new. Mercedes engineers long banked on high-performance diesel rather than electric engines. No longer. "It's clear that a dramatic transition period has started," says Thomas Weber, head of R&D, "and we want to actively shape it."

It's a risky strategy. Electric cars, even mild hybrids, remain expensive, and the market potential is far from clear. Lithium-ion battery technology, too, is tricky and hasn't yet been tested on a large scale; Toyota's Prius, which blazed the trail for hybrid vehicles, uses nickel-metal hydride technology. Moreover, as consultant Schmidt points out, Mercedes came to grief in the early part of this decade because of a heavy reliance on fancy electronics that turned out to have bugs. "They already learned the cost of trying to run before you can walk," he says, "and now they are doing it again."

But Weber is adamant that "electric mobility" is the wave of the future: "We are at the beginning of a trend whose end we cannot predict."

Another thing that's hard to predict is Daimler's future. When the economic crisis hit, the carmaker responded quickly. Can the company now apply that same determination to propel itself into a new era of profitability? Zetsche is sure it can; Wall Street remains skeptical. One thing is certain: No longer having Chrysler on its back certainly lightens its load.

Time to take off those ski boots and start running, Dr. Z. ■

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