

BARRON'S Online

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BARRON'S COVER

Lexus' Next Act -- Part II

[Cover Story -- Part I](#)¹

LEXUS' TOP-SELLING SEDAN, the comfortable, nicely appointed ES 330, out-sells all other luxury sedans, and its top-selling SUV, the RX330, is the king of that luxury category and is practically ubiquitous in affluent suburbs.

Before Lexus came along, no one would have dreamed of Toyota climbing to the top of the luxury world. The parent company's reputation rested almost entirely on building cheap cars for everyman. As one critic likes to say, embarking on the Lexus was the same as making "Beef Wellington at McDonalds." But, being a child of the Japanese auto giant also carried some terrific advantages, most specifically Toyota's deep pockets.

Today No. 2 in global auto output behind GM, Toyota was even before Lexus the largest of the Japanese auto makers and one of the more profitable. Moreover, based in a country with socialized medicine, Toyota had -- and still has -- hardly any "legacy costs," the huge burden of worker and retiree pension and health-care costs that hobble the U.S. car makers. Toyota is the world's most profitable car maker, generating higher operating profits than GM, Ford and DaimlerChrysler combined.

Lexus also benefited from production expertise that gave its company some of the most efficient, low-cost auto plants in the world. Lexus numbers are not broken out but, today, Toyota's worldwide network of about 50 plants often runs near 100% of capacity and the company boasts the three most efficient auto plants in the world.

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Lexus launched with some other advantages, including the raging stock market of the 1990s, which lifted luxury spending in general, and great demographics -- the baby boom generation was just getting ready to trade up from Toyota Camrys, Corollas and the like. Some rivals, meanwhile, had grown complacent.

"The European and U.S. luxury manufacturers were asleep at the wheel and that gave Lexus a window of opportunity," says Susan Jacobs, the president of New Jersey-based Jacobs and Associates, a consulting firm that tracks the luxury- auto market. "By the time they woke up, Lexus had unstoppable momentum."



2006 Lexus LS 430

Lexus' main aim, says Bob Carter, the group vice-president and general manager of Lexus' U.S. unit, "was to create the perfect product and the perfect customer experience."

Toyota went to unusual lengths to research what car buyers wanted, even sending the managers and engineers designing the product on week-long trips to America to live the life of the affluent. The work paid in the form of a strong identity for the new brand: vehicles that would reliably take you from Point A to Point B, with a good measure of comfort thrown in. "With a Lexus in your driveway, you knew that your friends knew that you had bought wisely," recalls Csaba Csere,

editor of Car and Driver magazine.

Indeed, Lexus has always placed high in long-term quality ranking. This year, for the 11th straight year, the brand was ranked No. 1 by J.D. Power and Associates in terms of the number of problems reported by new owners. Against an industry average of 237 faults per 100 cars, Lexus buyers reported just 139, beating out Lincoln at 151, Cadillac at 175, BMW at 225 and Mercedes at a troubling 283.

Whenever a new Lexus model hasn't measured up -- such as the over-priced original GS300, launched in 1993, and the IS300 in 2000 -- Lexus has been quick to pull the product and rework it. Not everything we have done has been successful," says Carter. "It's how we react to and learn from difficulties that makes us successful."

The other leg of Lexus' drive for perfection has been the "perfect" customer experience -- something that starts at the dealerships. Right from the earliest days, only the best of the Toyota bunch were invited to join the Lexus brotherhood. Quietly but firmly, the company rejected applications from others, preferring instead to sign up those handling rival brands. Even then, only 72 of 1,500 applicants received franchises.

Out went the plaid jackets for salesmen. In came luxurious, up-market showrooms with amenities not seen elsewhere, often including putting greens, big-screen TVs and, whenever requested, loaner cars to owners undergoing repairs. Lexus generally ranks high in dealer satisfaction, coming in fourth behind Lincoln, Cadillac and Saturn in 2005, according to J.D. Power.

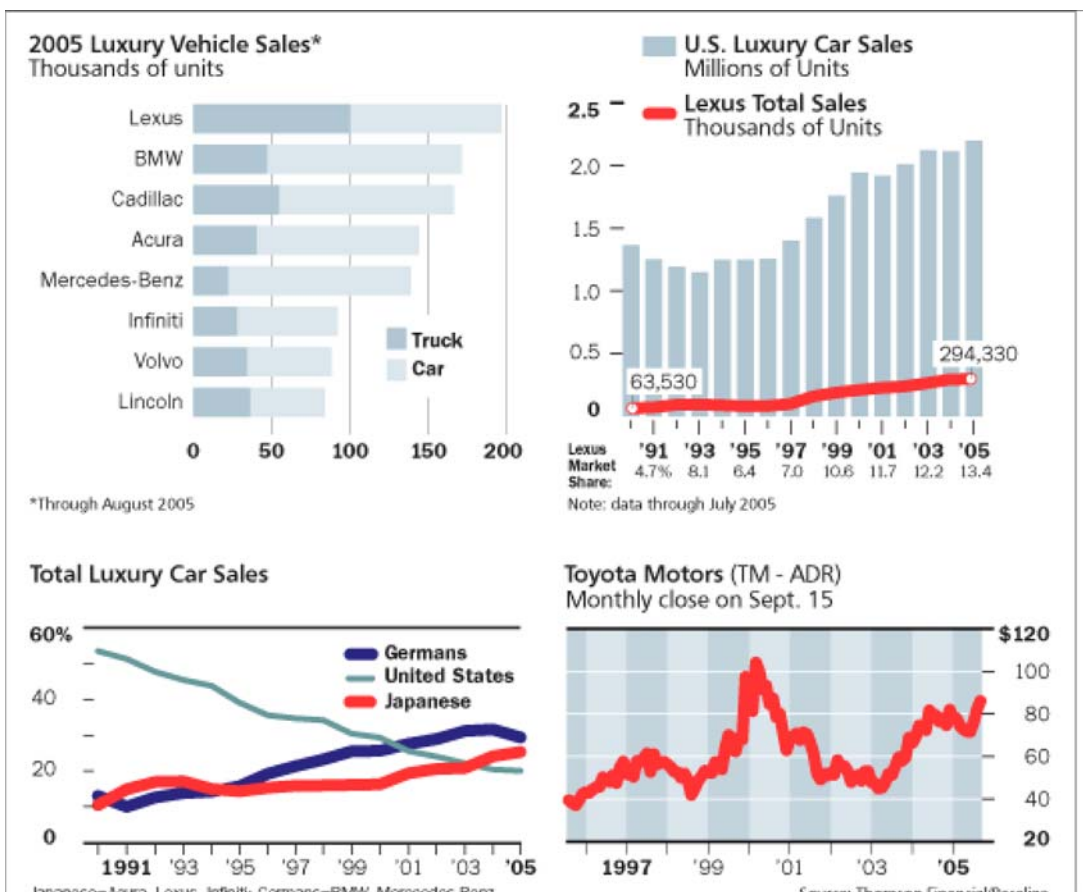
SO, WHAT'S NEXT? Lexus is aiming to boost U.S. output over the remainder of the decade from last year's 288,000 to at least 350,000, an annual growth target of 3.3%. That is more than most rivals are aiming for, but it is hardly unachievable, especially since the company has an above-average number of new car launches in the works. In the auto business, new always sells better than old.

In developing new models, Lexus is not following the pack, rejecting the move by many key rivals to launch lower-priced models, most notably the baby X-Type Jaguar, the A-Class Mercedes in Europe and the forthcoming 1 Series BMW. Such moves, Lexus is convinced, only harm reliability, brand image and eventually sales.

Instead, Lexus is considering a very up-market, super-luxury sedan that would sell for more than \$100,000. Lexus has been keeping the plans for the possible project under tight wraps, but the car would likely be positioned as a competitor to the 7 Series BMW or even certain Bentleys.

Meanwhile, to lessen its vulnerability to an SUV slump, Lexus is pushing in a big way toward fuel-efficient crossovers or SUVs built on car platforms, and gas-electricity hybrids. While the new RX400h hybrid SUV has generated lots of buzz as the first luxury hybrid SUV, the gasoline savings have disappointed some (see [Best in Class²](#)).

Next year, Lexus will launch the IS350 to crack BMW's lock on the lucrative sports-sedan market. This rear-wheel drive car is meant to have the performance and looks lacking in the current boy-racer model, the IS300, and will be available in sedan, coupe, and convertible



body styles.

"Performance is an obvious brand extension for Lexus," says Carter.

King of the Road -- Lexus is outselling all rivals in cars and truck-like vehicles such as SUVs, and the brand has been steadily gaining market share. But Lexus is more dependent than others on SUVs, a clear challenge with gas prices rising.

A new GS sedan will also

come to market, followed in '07, by a new ES sedan, a new LX SUV, a hybrid LS sedan and an LFX mid-size crossover. Over the next two years, there will probably be a new coupe as well as a new mid-size SUV and a hybrid RX crossover successor to the current 400h.

For all these new U.S. products, it's hard to escape the impression that Lexus is looking for much of its future growth outside the U.S. In fact, the company is looking for worldwide sales of 500,000 vehicles in '06, a 40% increase over this year's target.

A prime target is Europe where, despite being available for about 16 years, Lexus is not a well-known brand. Even so, Lexus aims to grow European sales to eventually match those in the U.S. It has developed a diesel engine, something that European luxury-car buyers demand, and it is pushing both its hybrids and its reputation for reliability.

"This is the one brand that can force its way onto the European stage," says Garel Rhys, the director of the Center for Automotive Industry Research at Britain's Cardiff University Business School. "It has product differentiation, a fully diversified product line and a reputation. The same market that Lexus appeals to in the U.S. is not very well served in Europe. The Germans are stumbling on quality and there are quite a few disgruntled BMW and Mercedes customers ready to switch brand."

THE COMPETITION ISN'T LIKELY to just roll over, however. New management at Mercedes promises more activity in Europe, while BMW aims to double sales worldwide, to 1.4 million, by 2008. Ford's financially troubled Jaguar unit is desperately pushing for higher volume, and Nissan's Infiniti is considering a European launch.

In Asia, where Lexus was poorly represented until this month's launch, the company is shooting for '06 sales of 60,000 vehicles. That may be a stretch. Though the Japanese economy is improving, auto sales as a whole remain stagnant and luxury-car sales continue to slide. In China, potentially the world's largest market, especially for luxury cars, Toyota has made some untypical mistakes -- and as a result Lexus has been slow off the mark compared to the already-booming sales of Mercedes and BMW in that country.

After Tokyo normalized relations with Beijing, Toyota was considered the odds-on favorite to lead the first wave of foreign investment. But the company waffled, focusing its efforts on the U.S., leaving the way open for GM and Honda to close deals with the leading Chinese auto makers. Only in 2002, with attractive dance partners disappearing, did Toyota sign a deal.

Ultimately, the most important factor in Lexus' favor may be its financial contribution to Toyota. Whatever the exact size, "One can be absolutely certain that the contribution is huge" says noted auto consultant MaryAnne Keller. As long as that remains so, and as long as Toyota remains the most profitable auto maker in the world, Lexus is going to be given the money that it needs to deliver reliability, performance and the new cars the markets demand. As Alexis of *Dynasty* knew so well, money is power.

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