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BY ALEX TAYLOR III

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Hyundai smokes the competition

PHOTO: GREGG SEGAL
Hyundai's chief technology officer, Hyun-Soon Lee, tests the aerodynamic properties of the 2011 Sonata.

By Alex Taylor III, senior editorJanuary 5, 2010: 9:45 AM ET (Fortune Magazine) -- On the second floor of the 21-story Hyundai Motor headquarters in the south of Seoul is a 24-hour operations hub, the Global Command and Control Center (GCCC). Modeled after the CNN newsroom in Atlanta with dozens of computer screens relaying video and data, it keeps watch on Hyundai operations around the world.

Parts shipments are tracked from the time they leave the supplier until they reach a plant. Cameras peer into assembly lines from Beijing to Montgomery and keep a close watch on Hyundai's giant Ulsan, Korea, plant, the world's largest integrated auto factory and the scene of frequent labor unrest.

Are competitors' spies lurking? The GCCC watches over Hyundai R&D activities in Europe, Japan, and North America, as well as its sprawling, 4,300-acre test facility in California's Mojave Desert, with its 6.4-mile oval track.

Almost no outsiders, and certainly no visitors from Fortune, are allowed inside the GCCC to view the operation firsthand. Hyundai employees aren't even supposed to talk about it. But its existence says volumes about how Hyundai views itself and the rest of the world.

PHOTO: GREGG SEGAL
When chairman Mong-Koo Chung took over from his father in 1999, he switched the company's focus from volume to high quality.

Hyundai is a confident, hyperaggressive company that not only wants to win, it expects to win. By monitoring operations in real time, Hyundai can identify problems in an instant and react quickly. It is a different philosophy for an auto company. Whereas Toyota (TM) thrives on consistency and Honda (HMC) on innovation, Hyundai is all about aggressiveness and speed.

These days Hyundai (rhymes with "Sunday") could get ticketed for exceeding the limit. Powered by a weak Korean won and a revitalized product line, it is ramping up volumes in major markets around the world.

Along with sister company Kia, of which it owns 39%, Hyundai has a hammerlock on Korea, with 80% of sales this year. In the U.S. generous incentives for retail customers and fleet purchases have pushed sales up a strong 7% in a market down 24%. November was a spectacular month: Hyundai brand sales jumped 46% from the previous year, and Kia rose 18%.

In China, where auto sales have skyrocketed this year thanks to government stimulus, Hyundai leaped 150% in September, leaving the company in second place, behind Volkswagen, among international automakers.

Behind the scenes at Hyundai

To take advantage of its momentum, Hyundai is pushing new models out of its factories faster and faster. American customers got to see the slick new 2011 Sonata in December, two months ahead of schedule, because, in an unusual move, Hyundai sped up the start of production.

Automakers hate to interfere with factory schedules because it is expensive, disrupts the flow of parts, and invites assembly problems. But Hyundai decided to move ahead. It was receiving good reads on early quality checks, suppliers showed ample stocks of parts, and engineers had prepped its Alabama plant. Speed became a competitive advantage.

Moving quickly and boldly has made Hyundai Motor Co. the fastest-growing major automaker in the world. Amid the global sales slump, it made a record $832 million in the third quarter ended Sept. 30. Analysts expect its net profits to rise almost 40% this year.

Despite its relative youth -- it is only 43 years old -- Hyundai already ranks fifth in volume among the world's auto producers, according to IHS Global Insight, and passed 107-year-old Ford Motor (F, Fortune 500) in 2009 to move into fourth place. Years ago Toyota used to say that Hyundai was the company it feared most. Today those fears have grown into a nightmare.

Despite their success, Hyundai executives keep pushing for more. Hyundai and Kia currently have capacity for 5.8 million cars and trucks. "We want to grow to 6.5 million units in two years," says Steve Yang, president and CEO, over a traditional multicourse Korean lunch at a small restaurant in Seoul.

Since Hyundai was expected to produce 5.2 million vehicles in 2009, that means a steep ramp-up if it wants to operate at full capacity. Western auto experts cringe at such a notion, because a big increase in volume can compromise quality and dilute brand equity. But Yang made the pledge with a smile as if he were merely exchanging polite chitchat. At Hyundai, it is understood that impossible targets are part of its way of doing business.

Sometimes speeding leads to accidents. Hyundai entered the U.S. market in 1986 with a single model, the Excel, which sold for $4,995 -- a price that so captivated bargain-minded Americans that Hyundai set a first-year record by selling 126,000 cars.

Its second year in business, Hyundai adopted the slogan "Cars that make sense" and set another record, selling 264,000 Excels. In its haste to grow, Hyundai made two near-fatal errors. It made fragile cars and sold them to noncreditworthy customers. When the cars were repossessed, their quality was so poor that they were worth less than the outstanding loans.

Hyundai is making another big gamble this year by introducing a premium luxury car called the Equus that is priced thousands of dollars higher than any car Hyundai has sold before. The Equus (Latin for "horse"), expected to cost around $60,000, will cost more than most Cadillacs and is designed to compete with top-of-the-line models marketed by Mercedes, BMW, and Audi that sell for $20,000 more.

Depending on your point of view, the introduction of the Equus is either ambitious, arrogant, or ignorant. Popular brands like Hyundai are not supposed to stretch into premium luxury territory; consumers want a prestige label when they pay a prestige price. Volkswagen found that out a couple of years ago when it tried to sell a $70,000 car called the Phaeton. Despite its technical excellence, potential buyers didn't associate the people's car with a high-priced sedan.

Test-driving the Equus

Judged on its merits, not its image, the Equus is a winner. Fortune had an opportunity to test one in Korea and found it surprisingly competitive with German luxury sedans under normal driving conditions.

The exterior could go on a chrome diet, but otherwise the Equus adheres to the conservative design standards required for luxury cars. The interior is best in class, intelligently crafted from fine materials and smartly laid out. The spacious rear seat, where many Asian buyers will spend their time, is equipped with a variety of diversionary devices, including one that provides a back massage.

Powered by a smooth, quiet, 4.6-liter V-8, the Equus should appeal to customers for whom value is a higher priority than association with a three-pointed star or dual-kidney grille.

No such identity crisis faces Kia, which got its start as a bicycle manufacturer and has become a power in its own right with a line of smaller, sportier cars. In the U.S. it markets six passenger cars and five crossovers with idiosyncratic names like Borrego, Rondo, and Soul, and has built its own U.S. plant in West Point, Ga.

Kias are typically priced below competing models and, loaded with options and carrying a strong warranty, represent an attractive value. From its U.S. market debut in February 1994, Kia has expanded methodically to become the eighth-most-popular brand in the U.S., outselling such stalwarts as Jeep, Subaru, and Lexus. Through November its sales had risen 8%.

How do the Koreans do it? In addition to getting big, Hyundai has gotten good. Once known as a cheap and cheerful brand that offered a comprehensive warranty to make up for mechanical shortcomings, Hyundai has become a respected name and a smart buy.

"Hyundai is a brand that is on the verge of being aspirational," says New York--based consultant and investor John Casesa. "People are saying they are proud to own it, not just to settle for it."

The evidence can be seen in the strengthening demographics of Hyundai owners. Last year some 49% were college graduates, compared with just 36% in 1999. By comparison, Toyota has a higher percentage of college grads -- 57% -- but the number hasn't grown much, up only two percentage points in 10 years.

New leadership, new focus

Hyundai's success reflects a shift in attitude that occurred nearly a decade ago. In the 1990s the company was more interested in how many cars it could build than in how good it could make them. That changed in 1999 when founder Ju-Yung Chung passed corporate leadership to his son, Mong-Koo Chung.

According to company lore, the younger Chung decreed that Hyundai would henceforth concentrate on quality, not volume. With the chairman behind the push, and with its characteristic intensity, Hyundai went after quality improvements with a vengeance.

Hyundai benchmarked Toyota, then the industry's quality leader, to understand its processes. It installed Six Sigma at its engineering center to measure its improvement. It made quality a cross-functional responsibility, with involvement from procurement, finance, and sales and marketing. It enlisted outside suppliers and put them together with designers and engineers to work out problems before they occurred. Quality oversight meetings, which had been poorly attended, became must-go events after chairman Chung began to show up for twice-monthly gatherings.

Three years ago legal problems diverted Chung from his quality push. In May 2006 he was indicted on charges of embezzling some $100 million from Hyundai and its subsidiaries for a political slush fund. He was detained by authorities for two months before being released on bail. The following February he was found guilty and sentenced to three years in prison. But an appeals court decided that he was too valuable to the Korean economy to be incarcerated and suspended his sentence.

At 71, Chung still takes an active role in the company. He typically arrives in the office by 6:30 a.m. and gets frequent briefings from the CEOs of Hyundai and Kia, as well as their subsidiaries. He has taken a particular interest in a new $5 billion mill being built by Hyundai Steel to make lightweight, high-tensile steel for automobiles, and travels to the construction site by helicopter as often as four times a week.

Chung, who rarely gives interviews to English-language publications, spoke with Fortune through an interpreter from his penthouse office in the Hyundai tower. Chung attributes his company's success to the investment it has made in improving its products. He believes that Hyundai's quality, as well as its technology, "are head to head with Toyota at this moment," a statement he makes with some confidence since "we are monitoring what is going on with Toyota all the time."

Asked what scares Hyundai the most, he replied, "The thing we fear is uncertainty. There are many announcements about demand shrinking, and all the numbers are different."

Hyundai's quality success is a testament to the power of focused management and aggressive goals. In 2001 Hyundai ranked 32nd out of 37 brands in J.D. Power's study of new vehicle quality after 90 days of ownership -- close to the bottom. As its quality efforts took hold, it began moving up the list, and it achieved a breakthrough in 2004 when it reached seventh place. Since then, Hyundai has placed third in 2006 and then fourth in 2009, displacing Toyota as the highest- ranked mass-market brand in the world. (Three luxury brands -- Lexus, Porsche, and Cadillac -- finished ahead of it.)

Characteristically, Hyundai is aiming yet higher. It has developed a two-part quality target it calls GQ 3-3-5-5, as Joon-Sang Kim, executive vice president of Hyundai-Kia's Quality Division, explained in an interview. Hyundai aims to finish in the top three in actual quality within three years as measured by Power's dependability survey -- and to finish in the top five in perceived quality in five years.

The first goal seems achievable. Hyundai has had solid, if unspectacular, success in the Power study, which measures problems experienced by original owners of three-year-old vehicles. From a rank of 35th out of 38 in 2001, it moved up to 20th by 2006 and kept climbing, finishing in 14th place in 2009.

Moving into the top five in perceived quality will be more difficult. That's because the rankings are based on the way outsiders perceive Hyundai. This year Hyundai ranked 11th in the brand-evaluation analysis performed by ALG (Automotive Lease Guide), which determines the residual value of cars for lease purposes.

At Hyundai Motor America's headquarters in Fountain Valley, Calif., the managers are learning they have to run fast to keep up with their Korean bosses. "Hyundai is an ambitious company that looks for boldness and leadership," says John Krafcik, president and CEO, who once referred to his employer as the "hardest-working company on the planet."

Having toiled under Jac Nasser at Ford, Krafcik, 48, is an expert on boldness and hard work, and he knows the industry from the inside out. Trained at MIT, he visited assembly plants around the world for the 1989 study "The Machine That Changed the World," about the Toyota manufacturing system, and he coined the term "lean production."

Krafcik joined Hyundai after 14 years at Ford overseeing development of SUVs, and he ascended to the top job at Hyundai America after one of its periodic management shakeups, the fifth in six years.

After working in Detroit's belt-and-suspenders culture, the boyish Krafcik delights in the challenges presented by Hyundai's determination to break rules. "One of the reasons we move fast is fewer people," says Krafcik. "Speed doesn't suffer bureaucrats well."

A willingness to take risks also keeps things moving. "Typically," adds Krafcik, "when we set targets, we haven't yet made a plan for how to get there." Krafcik says that when the company vowed to achieve a corporate fleet average fuel economy of 35 miles per gallon by 2015, a year ahead of the government deadline, it wasn't sure how it would do it.

Hyundai also likes to wait until the last possible moment to make decisions. "When developing a new model," says Krafcik, "companies typically sign off on the characteristics of the powertrain 4 1/2 months before production. Hyundai waits until a month ahead so that it can incorporate the most recent performance data." It's a technique that allows it to stay close to its customers, but it also increases the likelihood of mistakes.

Nothing shows off Hyundai's opportunistic culture better than its U.S. marketing team. Headed by Joel Ewanick, who joined Hyundai in February 2007 after stints at Porsche, Yamaha, and Hinckley Yachts, it operates like the war room of a political campaign, making lightning strikes when it sees an opportunity.

A year ago it noticed growing fears among customers about unemployment, so it developed a program that allowed them to return their new Hyundais risk-free if they lose their jobs. Pulling together such a program -- which included production of a TV commercial shown during the 2009 Super Bowl -- would take several months at other companies, but Hyundai marketers got the job done in 37 days. The campaign, called "Assurance," won Hyundai enormous amounts of attention and goodwill, even though only about 100 customers returned their cars.

Ewanick, 49, says programs like that are vital because buyers no longer respond to traditional cash and interest-rate promotions. He is looking for new ways to create showroom traffic. Last summer he devised the "Assurance Gas Lock," which guaranteed customers $1.49-a-gallon gasoline for a year.

Then Hyundai beat the government's Cash for Clunkers program to the punch by offering tax credits to buyers several weeks before the program started. "Customers want to be involved with the brand," says Ewanick. "Incentives aren't enough. We want to break away and have Hyundai be considered as more than a car company."

That doesn't mean that Hyundai doesn't use incentives -- and use them very effectively. It just does so where the consumer can't see them but where they drive down the transaction price.

Consultant Kimberly Rodriguez of Grant Thornton in Detroit cites data showing that Hyundai was spending $2,825 per car on incentives for the first 10 months of 2009 -- more than any other Asian manufacturer -- and selling lots of excess production into rental-car fleets. "They are clearly taking advantage of a lull in the action," says Rodriguez, "and with currency in their favor, they can afford to do it."

Whatever the attraction, customers seem to be getting a new message about Hyundai. Five years ago Hyundai was known for its low prices, so-so quality, and a 100,000-mile powertrain warranty. Today, Ewanick says, Hyundai stands for softer, more positive qualities like smart, fresh, and high-tech. "Consumers," he says, "want brands that feel the same way they do about society and the environment. But they don't want to pay for it."

Labor union disputes to Genesis' success

The automaker's origins date back to the Hyundai Engineering & Construction Co. (Hyundai means "modernity" in Korean), which was founded after World War II and created Hyundai Motor in 1967. Thanks to high tariffs that rebuffed foreign manufacturers, the motor company thrived and was spun off as a separate enterprise in 1998.

That same year it acquired a controlling stake in rival Kia, which was struggling from the Asian financial crisis. Gradually the two companies are consolidating around common functions for economies of scale, but they are keeping the Hyundai and Kia brands separate for marketing and distribution purposes: Hyundai is positioned as the responsible adult, while Kia is the mischievous adolescent.

Hyundai's growth was accompanied by a decade of labor union disputes that produced paralyzing strikes. Labor rights in South Korea had been long suppressed, and a series of healthy pay increases kept its militant labor unions at bay until the mid-1990s.

But the financial crisis as well as an industry slump brought the strikers out in force, and Hyundai was hit by a seemingly endless number of work stoppages. A 47-day walkout in 2003 cost Hyundai an estimated $1.2 billion in exports. Since then a measure of labor peace has been restored. The strikes haven't become a thing of the past -- there is usually one a year -- but the level of vitriol has been reduced.

In the U.S., Hyundai spun its wheels for a decade after the Excel fiasco, selling inexpensive cars to lower-income customers as it churned through a succession of U.S. sales executives who failed to meet its aggressive targets. But along with improved quality, Hyundai began to pay attention to international designs with greater market appeal. Its cars developed cleaner lines with more elegant details as Hyundai moved away from traditional Korean styles, which tend to be baroque and fussy.

The two trends -- better quality, sharper designs -- came vividly together in 2008 with the launch of the Genesis sedan. A step up from the midsize Sonata, Hyundai's best U.S. seller, the Genesis is powered by a V-6 engine (with an optional V-8) and is designed to compete in the so-called entry luxe segment with cars like the Lexus ES 350.

The journalists who judge the North American Car of the Year competition made it the surprise winner in 2009, an award Ewanick and his team promptly made a centerpiece of their advertising. With a starting price of $32,250, the Genesis was recognized by customers as an attractive value, and they have been buying more than 1,500 units a month. The success of the Genesis in such a highly competitive segment signaled Hyundai's arrival as a top-tier manufacturer.

Speedy in most matters, Hyundai has been a laggard when it comes to developing alternative-fuel vehicles. It didn't introduce its first fuel-saving hybrid until last summer, a decade after Toyota started selling the Prius. Typically, Hyundai's ambitions remain huge. Despite its late start, it has stated its intention to sell 500,000 hybrids a year by 2018. Hyundai has developed a lithium-polymer battery that is 40% smaller and weighs 35% less than conventional nickel-metal-hydride ones used in the Toyota Prius.

A wave of new models should keep both Hyundai and Kia hustling over the next few years. The two companies are due to turn over their entire U.S. product line in the course of the next four years, the highest replacement rate in the industry, according to a forecast by Merrill Lynch/Bank of America's John Lynch. He sees Hyundai and Kia gaining 3 1/2 points of market share over the span. That would be enough to vault the Koreans past Chrysler and Nissan into fifth place in the U.S., with a share of 10.8% by 2013.

The old bumper sticker used to preach that speed kills, but Hyundai shows no signs of slowing down -- and so far has no need to report any casualties.